



Electronic Tax Administration Advisory Committee

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# Electronic Tax Administration Advisory Committee

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# PREFACE

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The Electronic Tax Administration Advisory Committee (ETAAC) was formed and authorized under the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98). ETAAC's primary charter is to provide input to the Internal Revenue Service (IRS) on the development and implementation of the IRS strategic plan for electronic tax administration. Accordingly, ETAAC's responsibilities involve researching, analyzing, and making recommendations on a wide range of electronic tax administration issues.

Pursuant to RRA 98, ETAAC reports annually to Congress concerning:

- Progress of the IRS in reaching its goal to receive electronically 80% of tax and information returns;
- Status of IRS strategic plan for electronic tax administration;
- Legislative changes assisting the IRS to meet the 80% goal; and,
- Effects on small businesses and the self-employed of electronically filing tax and information returns.

IRS ensures ETAAC membership reflects broad experience and stakeholder perspectives, including representation from state departments of revenue, large tax preparation companies, solo tax practitioners, software companies, and business filers from both the non-profit and for-profit sectors. ETAAC member biographies are in Appendix A.

In conducting its assessments and formulating its recommendations, ETAAC relies on a variety of information sources. Most importantly, ETAAC participated in numerous discussions with IRS representatives. ETAAC also reviewed several reports, including those from the IRS Oversight Board (Oversight Board), the National Taxpayer Advocate, the Government Accountability Office (GAO), and the Treasury Inspector General for Tax Administration (TIGTA). The Committee is most grateful for their observations. Finally, on occasion, ETAAC sought background insights from both industry and state departments of revenue. Notwithstanding the foregoing, the recommendations and opinions expressed in this report are solely those of ETAAC.

The Oversight Board, also established pursuant to RRA 98, has among its duties the delivery of an annual report to the Director of Electronic Tax Administration (or other IRS delegate) and a similar Congressional reporting responsibility with respect to advancing electronic tax administration. Over the past years, the Oversight Board and ETAAC have concurred in many opinions and recommendations on the IRS' progress in the areas of electronic filing and electronic tax administration. Both the Oversight Board and ETAAC look forward to continuing to do so in the face of industry-wide changes and expectations from the tax paying community served.

Finally, ETAAC recognizes the employees and leadership of the IRS for their continued efforts to administer an increasingly complex tax system, meet taxpayer service expectations, and successfully process billions of transactions and hundreds of millions of tax returns. The United States tax system could not operate without their dedication, commitment, and talent. IRS employees and managers made themselves available during the filing season and on many other occasions to brief ETAAC on a variety of issues and initiatives, answer questions, and provide requested information despite their demanding schedules. ETAAC appreciates their dedication, openness, and candor. Without the continuing and full support of IRS, ETAAC could not perform the job the IRS has assigned to this Committee.

Public comments on this report may be sent to [etaac@irs.gov](mailto:etaac@irs.gov).

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# EXECUTIVE SUMMARY

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ETAAC's key observations and recommendations for 2012 are below along with a brief recap of last year's progress and recommendations. The remainder of this Report is organized into major sections covering ETAAC's analysis, assessment, and recommendations.

## 1. IRS REACHES A MILESTONE OF SUCCESS IN FILING SEASON 2012 RELATED TO THE 80% E-FILE GOAL

IRS and industry exceeded the 80% participation rate for Individual tax returns from the 1040 group filed during 2012.

## 2. IRS CONTINUED PROGRESS TOWARD ETAAC'S 2011 RECOMMENDATION AREAS

IRS made progress in key areas related to ETAAC's 2011 recommendations for driving the implementation of the preparer oversight initiatives and increasing the volume of returns filed under the 1040 Modernized e-file (MeF) platform during the filing season. Opportunities for progress remain in other important areas, including increasing electronic filing of employment returns, reducing e-file rejects, increasing taxpayer and tax preparer tools and resources, and leading enhanced industry collaboration and partnership.

## 3. THE FUTURE ENVIRONMENT CONTINUES TO INCREASE IN COMPLEXITY AND CHALLENGE

IRS faces ever-increasing budget and environment challenges as it deals with increased tax complexity, expanded responsibilities, reduced budgets, and increased taxpayer expectations. IRS needs to assess its investment decisions and resource allocation rigorously, make the right tradeoffs and, importantly, challenge its current way of "doing business" by implementing new and innovative business processes and collaborative engagements with industry and states.

## 4. RECOMMENDATIONS IN FIVE KEY AREAS

For 2012, ETAAC is making 12 recommendations to drive five key outcomes.

**Key Outcome 1:** Reinforce tax industry software technology and infrastructure standards regarding security, privacy, fraud prevention, and e-authentication to promote and safeguard taxpayer data and confidence in the tax system.

**Key Outcome 2:** Continue to focus on the growth, improvement, and consistency of the 80% electronic filing goal on major return types.

**Key Outcome 3:** Empower taxpayers and tax return preparers and effect more accurate tax returns through effective delivery of taxpayer services through the internet and established tax industry relationships.

**Key Outcome 4:** Leverage tax service delivery channels from the private sector with tax software developers and tax preparation companies to enhance and improve tax service delivery and thereby confidence in the overall electronic tax system by partnering and collaborating more.

**Key Outcome 5:** Congress should continue to fund the Modernization Program, which includes Modernized e-file (MeF) and the Customer Account Data Engine (CADE 2). This will allow the IRS to continue to focus on the final implementation of MeF and CADE 2 while maintaining Legacy another year as a contingency.

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# 1 PROGRESS TOWARD 80% E-FILE GOAL AND CONSIDERATIONS FOR THE FUTURE

From its foundation, one of ETAAC's primary responsibilities has been to comment on and assess IRS' progress toward achieving its 80% e-file goal for major returns.<sup>1</sup> IRS made progress during the most recent tax year with a 2.5% increase in electronic filing of major returns. IRS can continue to make progress in years to come and secure and protect gains already made, but the gains will be smaller each year and will be more difficult to achieve. That said, the current year was a milestone year for electronic filing in many respects and in particular with regard to the electronic filing of individual tax returns.

In keeping with historical analysis and reporting, ETAAC continues an electronic filing index (Index) for use in this Report. The Index assesses the e-file rates of a defined set of major tax returns, including a methodology to project full year e-file rates based on "season to date" information for the main driver of electronic filing rates – the individual tax return. Details about the Index and ETAAC's methodology are in Appendix B.

## 1.1 ANOTHER YEAR OF E-FILE GROWTH FOR IRS MAJOR RETURN TYPES

ETAAC estimates a 69.81% e-file rate for all major return types in 2012

**Table 1: 2009 – 2012 Electronic Filing Index**

Electronic Filing Rate	2009	2010	2011	2012 Projection
EFI	56.94%	60.07%	67.31%	69.81%

Source: June 2011 ETAAC Annual Report to Congress, IRS Publication 6186 (Rev. 10-2011) Table 2 and actual data through 4/27/12 with historical analysis of rate degradation. See Appendix B.

The Index continues to be driven by the individual return electronic filing rate, which is projected to be 80.38%<sup>2</sup> in 2012. This is the first time the e-file rate for the individual return family has exceeded the 80% e-file goal. ETAAC wishes to congratulate everyone involved in achieving this milestone.

**Table 2: 2012 Projected Electronic Filing Index (EFI)**

Type of Return	2012 Projection		
	Total	E-Filed	EFI
Individual (Forms 1040, 1040-A, and 1040-EZ)	144,565,800	116,202,821	80.38%
Employment (Forms 94x)	29,154,300	7,570,000	25.97%
Corporation Income Tax (1120, 1120-A, 1120-S)	6,518,600	3,139,400	48.16%
Partnership (Forms 1065/1065-B)	3,589,900	2,056,100	57.27%
Fiduciary (Form 1041)	3,071,200	1,742,600	56.74%
Exempt Organizations (Forms 990, 990-EZ)	635,800	213,600	33.60%
Total	187,535,600	130,924,521	69.81%

Source: IRS Publication 6186 (Rev. 10-2011) Table 2. Calendar Year Projections of the Number of Returns to be Filed with IRS. See Appendix B.

- 1 In the 80% goal, IRS considers the major tax returns filed by individuals, businesses, and tax-exempt entities. IRS Strategic Plan 2009-2013, Pub. 3744 (4-2009) (IRS Strategic Plan). As used in ETAAC's report, "major types of tax returns" refers to the most significant of those returns as identified in 2012 ETAAC Report, Appendix B.
- 2 Typically, the percentage of paper returns filed between the April filing deadline and the end of the filing season in October increases, reducing the e-file rate. ETAAC projects the full year individual e-file rate at the end of the season will be approximately 3% lower than the rate as of April 2012. See Appendix B, Table 12

The current EFI for all major returns displayed modest growth overall of approximately 2.50% as compared with the 7.24% growth seen in 2011. ETAAC attributed the majority of the growth in 2011 to the increase in the Individual return category that year. The increase in the Individual return EFI was 2% for 2012. ETAAC believes the relatively modest growth in 2012 was caused by 1) The majority of the EFI increase available due to the new preparer e-file requirements was realized in 2011; and 2) As the e-file rate for Individual returns approaches and exceeds the 80% threshold, there are fewer opportunities to make significant gains in the Individual return category.

## 1.2 ETAAC 2011 PROJECTION RESULTS

In ETAAC's June 2011 Report, ETAAC projected the e-file rate for Individual returns (Forms 1040, 1040-A, and 1040-EZ) of 77.31% and projected an EFI for all major returns of 65.82%. The e-file rate for Individual returns for 2011 is 77.77% with an EFI of 67.31% for all major returns. The same projection methodology was used in the 2012 report and can be found in Appendix B.

**Table 3: 2011 IRS Data vs. EFI Projection**

2011 IRS Data vs EFI Projection			
Type of Return	EFI	IRS Data	Variance
Individual (Forms 1040, 1040-A, and 1040-EZ)	77.31%	77.77%	0.46%
Employment (Forms 94x)	23.78%	25.05%	1.27%
All Major Returns	65.82%	67.31%	1.49%

Source: IRS Publication 6186 (Rev. 10-2011) Table 2 and June 2011 ETAAC Annual Report to Congress.

## 1.3 INFORMATION RETURNS

ETAAC is charged with reporting on not only tax returns, but on information returns as well. Because the volume of Information Returns far exceeds the volume of the major tax returns considered in the EFI, ETAAC has broken out information returns into its own category. The EFI for all information returns is near 90%. As the EFI for these returns exceeds the 80% threshold, they are not addressed in detail in this report.

**Table 4: Information Returns to Note**

Type of Return	2012 Projection		
	Total	Paper	EFI
W-2 wage and tax statement	234,097,900	74,200	99.97%
1099 Miscellaneous	92,600,500	31,243,800	66.26%
Total	326,698,400	31,318,000	90.41%

Source: IRS Publication 6961 (7-2011) Catalog Number 59088W Table 1. Comparison of Projections Made in 2010 vs. 2011 for Calendar Year 2012 (some data rounded).

However while the category of Information Returns as a whole exceeds the 80% threshold, ETAAC has noted a few of the major Information Return types affecting individual tax returns, namely the 1099-Misc is well under the 80% threshold. It is important to note there are nearly 31 million paper-filed 1099-Misc forms. ETAAC also raises the issue in the current political environment, and considering recent and pending legislation, ETAAC is noting this number has the potential to grow significantly.

A large number of paper-filed 1099-Misc forms would create a significant barrier to any real-time tax reporting or matching system. ETAAC discusses this in ETAAC Recommendation 6.

#### 1.4 GROWTH OF INDIVIDUAL RETURN E-FILE DROVE THE OVERALL E-FILE GROWTH RATE

IRS and industry drove yet another increase in the electronic filing of individual tax returns in filing season 2012. This resulted in a 6%<sup>3</sup> increase in the number of electronically filed individual returns over last year as of the end of the primary filing season,<sup>4</sup> and an overall e-file rate in excess of 80%. However as the full effects of the preparer requirements are realized, and the e-file rate continues to exceed 80%, ETAAC anticipates the e-file growth in the individual return category will be modest. While it is imperative for the IRS to continue its focus on the Individual return category, IRS must increase the other return categories to achieve the broader 80% goal.

**Table 5:** Estimated and Projected Calendar-Year Electronic Filing Index

Type of Return	2011 Estimated			2012 Projection			2012 vs. 2011	
	Total	E-Filed	EFI	Total	E-Filed	EFI	E-File Unit Growth	Increase in Rate
Individual (Forms 1040, 1040-A, and 1040-EZ) <sup>1</sup>	142,396,100	110,743,300	78%	144,565,800	116,202,821	80%	5,459,521	2%
Employment (Forms 94x)	29,079,500	7,284,200	25%	29,154,300	7,570,000	26%	285,800	1%
Corporation Income Tax (1120, 1120-A, 1120-S)	6,456,000	2,944,700	46%	6,518,600	3,139,400	48%	194,700	2%
Partnership (Forms 1065/1065-B)	3,511,600	1,771,900	50%	3,589,900	2,056,100	57%	284,200	7%
Fiduciary (Form 1041)	3,031,900	1,660,000	55%	3,071,200	1,742,600	57%	82,600	2%
Exempt Organizations (Forms 990, 990-EZ)	624,200	187,500	30%	635,800	213,600	34%	26,100	4%
Total	185,099,300	124,591,600	67%	187,535,600	130,924,521	70%	6,332,921	3%

Source: IRS Publication 6186 (Rev. 10-2011) Table 2. Calendar Year Projections of the Number of Returns to be Filed with IRS (some data rounded).

Table Notes: (1) 2012 Based on actual data through 4/27/12 with historical analysis of rate degradation during the extension-filing period for full year Projection – See Appendix B.

The year-over-year full-year comparisons in Table 5 provide a clear indication of IRS' e-file opportunities. In particular, the lack of e-file growth in employment returns will become the biggest barrier to IRS' progress towards the 80% goal, and must be addressed.

#### 1.5 CONTINUE TO DRIVE INCREASED ELECTRONIC FILING OF INDIVIDUAL RETURNS

Although the 80% goal for individual tax returns was surpassed in 2012, IRS and industry cannot relax and consider the issue of electronic filing successfully implemented. Individual returns otherwise known as the 1040 series account for the largest number of tax return types by a factor of almost five and are accordingly a primary focus to maintain high and sustained levels of electronic filing in order for the overall electronic infrastructure to be successful.

ETAAC believes there are several key areas to continue increasing the e-filing of individual returns and sustaining the currently achieved levels.

<sup>3</sup> See <http://www.irs.gov/newsroom/article/0,,id=257083,00.html>

<sup>4</sup> "Primary filing season" refers to the filing period from January through mid-April.

## Preparer-Generated Returns

Filing season 2012 was the second and final transition year of IRS' implementation of the professional preparer electronic filing requirement requiring tax professionals of a select size to electronically transmit all tax returns. Gross electronic filing volume by professional preparers grew about 4% as of April 27, 2012 up to 69,846,000 from 67,082,000 last year. The move to mandate electronic filing of tax returns by professionals clearly had a positive electronic filing impact, more so last year with lesser impact in the current year. Additionally, this filing season was the first year in a multi-year process by which the IRS will add additional oversights to the tax preparer community with a series of requirements to improve professional standards. 2012 is the first year of the Registered Tax Return Preparer competency test whereby tax preparers were tested to ensure a basic knowledge of tax technical skills. The test was successfully launched and all unenrolled preparers are required to pass the test by December 31, 2013. The percentage of individual returns electronically filed by preparers and consumers based on relative year volumes remained relatively stable at 63% versus 37% contrasted with 64% and 36% for last year respectively.

**Table 6:** 2012 Primary Filing Season: Electronic Filing vs. Paper Filing

Individual (Forms 1040, 1040-A, and 1040-EZ)	2011 (Through 04/29/2011)		2012 (Through 04/27/2012)	
	Total	%	Total	%
All Electronically Filed:	104,936,000	80%	111,325,000	83%
Preparer (%Displays Share of E-File)	67,082,000	64%	69,846,000	63%
Consumer (%Displays Share of E-File)	37,854,000	36%	41,479,000	37%
Paper Filed:				
All Categories <sup>1</sup>	25,756,000	20%	22,135,000	17%
<b>Total</b>	<b>130,692,000</b>		<b>133,460,000</b>	

Source: <http://www.irs.gov/newsroom/article/0,,id=257083,00.html> (Data Rounded)

## Reduce E-File Rejects

IRS must work with industry to reduce the significant number of e-file rejections. For the better part of recent history electronic filing of individual tax returns consistently had a 15-20% e-file reject rate, which is unacceptable – one in five taxpayers' individual returns should not be rejected. Rejects create significant anxiety for those already having made a decision to e-file. The most notorious cause of rejects, which has remained consistent, is IRS' current identity proofing mechanism – the AGI/PIN signature. A close second is the incorrect matching of taxpayers and dependents and their required social security numbers. ETAAC believes there are additional options and solutions to prevent the current level of rejects and, in fact, may assist with reducing fraud. IRS will not achieve an overall 80% electronic filing rate in all major return types and maintain taxpayer system confidence until it addresses and reduces individual return rejects in a focused, persistent, and collaborative effort with industry. Select considerations for improving reject administration and management are noted under ETAAC Recommendation 7.

## Other Self-Prepared Returns

Electronic filing volume of individual returns by consumers using software to prepare their returns continues to be steady (see Table 6). The majority of these returns are prepared by the actual taxpayer. However, two sets of returns are not electronically filed: (1) the self-prepared, paper-filed tax return and (2) the return prepared by another for compensation and filed as self-prepared, also known as "phantom prepared" returns. IRS should continue to foster a credible, financially healthy, and

competitive consumer tax software industry, and find creative ways to promote the benefits of electronic filing to the group of taxpayers who currently prepare and submit a paper filed return to the IRS. Additionally, “phantom prepared” returns lack accountability and in many cases may lack accuracy thereby undermining the efforts of the return preparer initiative taken on by the IRS and confidence therein. The number of returns prepared by phantom preparers is difficult to determine but industry speculation indicates a growing trend. If left unchecked this could create significant issues to the tax system. From lack of accountability, no professional training, and limited experience to outright preparer fraud, the increase in individuals who prepare a tax return for compensation and do not sign the tax return needs creative solutions to maintain gains in professional preparation standards and for taxpayer confidence to be maintained in the system.

## 1.6 INCREASE THE EMPLOYMENT RETURN ELECTRONIC FILING RATE

ETAAC estimates an additional 19 million more returns must be e-filed if the IRS is to achieve its overall 80% goal. With approximately 28 million paper returns remaining in the Individual return category, it would be a daunting task to achieve the 80% goal without engaging the other return families. The largest e-file gap remains in the employment return family, primarily Forms 940 and 941 (Forms 94x). These returns are projected to have a 2012 e-file rate of approximately 26% and have the largest volume gap to achieve the 80% goal for that form type – about 16 million returns. It is highly improbable the IRS can achieve an overall 80% EFI without increasing the e-file rates of the 94x series.

**Table 7: E-File Gap**

Type of Return	2012 Projection			80% EFI Goal		
	Total	E-filed	EFI	Total E-Files Required	Numeric Gap <sup>1</sup>	Percentage Gap <sup>2</sup>
Individual (Forms 1040, 1040-A, and 1040-EZ)	144,565,800	116,202,821	80%	115,652,640	(550,181)	0%
Employment (Forms 94x)	29,154,300	7,570,000	26%	23,323,440	15,753,440	54%
Corporation Income Tax, Total	6,518,600	3,139,400	48%	5,214,880	2,075,480	32%
Partnership (Forms 1065/1065-B)	3,589,900	2,056,100	57%	2,871,920	815,820	23%
Fiduciary (Form 1041)	3,071,200	1,742,600	57%	2,456,960	714,360	23%
Exempt Organizations (Forms 990, 990-EZ)	635,800	213,600	34%	508,640	295,040	46%
<b>Total</b>	<b>187,535,600</b>	<b>130,924,521</b>	<b>70%</b>	<b>150,028,480</b>	<b>19,103,959</b>	<b>10%</b>

Source: IRS Publication 6186 (Rev. 10-2011) see Table 2. Calendar Year Projections of the Number of Returns to be Filed with IRS (some data rounded).

Table Notes: (1) Approximate number of additional e-filed returns required to achieve 80% goal for each of the major types of tax returns. Individual Forms manage an excess over the 80% goal reducing the gap for other categories.

(2) Approximate percentage of additional e-filed returns required to achieve 80% goal for each of the major types of tax returns.

Both the Oversight Board and ETAAC have identified the need to investigate the root cause of low e-file rates for Forms 94x. In the June 2011 Annual report to Congress, ETAAC conducted its first initial in-depth review of employment returns and offered several observations and recommendations in this area. ETAAC has continued that analysis in the ETAAC 2012 Recommendation 5.

## 1.7 SIGNIFICANT INCREASES SEEN IN ELECTRONIC INTERACTIONS WITH IRS

Taxpayers' electronic interactions displayed a significant increase in tax season 2012. Use of www.irs.gov made huge gains with a 20% increase, and the utilization of electronic direct deposit of refunds was up 4.49%. Furthermore, the IRS released several new tools and applications resulting in favorable acceptance and usage rates as compared to volume. This trend exemplifies the need for the

IRS to remain diligent in its commitment to the electronic infrastructure, enabling the adoption of IRS technology by its consumer base and ultimately the e-file program. This consistent and growing usage level shows taxpayers are ready, willing, and able to accept, use, and demand ever increasing levels of electronic support and interaction. The IRS should continue to maintain the focus and development of tools and resources for direct interaction with taxpayers and tax return preparers.

**Table 8:** Other Electronic Interactions Cumulative Data

Type	Tax Year		Growth
	2011 (01/01 - 4/29)	2012 (01/01 - 4/27)	%
Visits to IRS.gov	204,221,980	245,686,041	20.30%
Visits to Where Is My Refund	53,112,008	103,477,821	94.83%
Refunds:	98,213,000	99,104,000	0.91%
Direct Deposit	74,653,000	78,007,000	4.49%
Other (Paper check, etc.)	23,560,000	21,097,000	-10.45%

Source: <http://www.irs.gov/newsroom/article/0,,id=257083,00.html>

## 1.8 THE 80% E-FILE GOAL AND THE FUTURE

As noted above and throughout this report, the IRS achieved an 80% participation level for individual tax returns for tax year 2011. However, overall the goal of 80% participation for major returns is lacking and likely to be so for some time. It is clear increasing electronic interaction and compliance with the IRS is gaining acceptability if not preference overall, based on the growth and success of other electronic interactions with the IRS. Examples such as IRS.gov uses, electronic refund participation, electronic filing of information returns, and the growth of tax based computer and smartphone applications, as well as other electronic interactions prove this. Going forward the IRS and other oversight bodies would be well served to reevaluate in broader context the original “80% E-File goal” and determine a more robust goal and more meaningful measurement scheme. ETAAC is content with the EFI for major return participation but feel it could be improved to incorporate more dynamic metrics and measures of total tax life cycle electronic interactions status and success.

## 2 PROGRESS TOWARD 2011 RECOMMENDATIONS

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IRS addressed several elements related to ETAAC's 2011 recommendations.

### 2.1 STANDARDS FOR THE ELECTRONIC COMMUNITY

IRS should set appropriate standards for the electronic tax community in the key areas of security and accuracy.

IRS has agreed with the substance of the recommendations related to security and accuracy of the digital infrastructure of the electronic filing program. However, due to current resource constraints for human capital and technology resources, the IRS must continue to carefully balance priorities when developing future plans while keeping a vigilant eye on all areas of opportunity.

### 2.2 MeF IMPLEMENTATION

Congress should fully fund MeF and IRS should complete MeF implementation as well as take prompt action to work with industry to reduce the volume of e-file rejects.

The IRS implemented the balance of the individual forms in the MeF program for tax year 2011. At the start of tax season filing, the IRS encountered issues that were corrected within an acceptable time-period. For example, downstream processing of selected taxpayers returns had some problems, which had a negative impact on the taxpayers. Although the issue with the downstream processing was not directly caused by the MeF system, returns filed under the legacy system did not experience the same negative impact. The IRS worked to communicate with industry and other partners throughout the implementation stage of MeF and during the filing season. In summary, the MeF platform seems almost fully implemented and IRS can work to refine and enhance all electronic filing systems including reject volume and fraud prevention and detection efforts. Due to the problematic issues with MeF / downstream systems at the start of season, continuation of the Legacy system for one more year, as a safeguard should be considered. See current year Recommendation 11.

### 2.3 EMPLOYMENT TAX RETURNS

IRS should focus more attention on increasing the electronic filing of employment tax returns and, particularly, Forms 940 and 941

The Committee is encouraged by the IRS commitment to create a service-wide team for improving the communications and outreach related to electronic filing of Forms 940 and 941. ETAAC is hopeful the IRS team will soon be announced, and quickly begin work on a comprehensive communication and outreach plan. ETAAC urges the IRS to improve communications both internally and externally in order to increase participation in the electronic filing of these forms. Furthermore, ETAAC continues to recommend the IRS investigate cost effective ways to increase e-filing these simple forms.

## 2.4 ACCELERATED INFORMATION REPORTING

IRS should begin engaging with industry to discuss the Commissioners' vision for accelerated information reporting and real time data matching, but defer any further consideration of Simple Return.

IRS has initiated a good public dialogue on the issue of accelerated information and real time data matching hosting public hearings and reaching out to industry and the public for input. Future interaction to gather additional input and public sentiment is planned and the need for more in depth analysis and evaluation of any large-scale change to information filing requirements and deadlines is still appropriate. ETAAC recognizes the Commissioner's vision of any real time tax systems is not a prelude or step to a "simple return" or pre-populated tax return although such a system could serve as a basis for such concept. While a basis may exist, for such a consideration in the future, the simplification of substantive elements of the tax code as well as taxpayer third party information submission deadlines must be taken into account.

## 2.5 COLLABORATION WITH ELECTRONIC TAX ADMINISTRATION STAKEHOLDERS

IRS should increase and focus its collaboration with electronic tax administration stakeholders to drive efficiency, lower cost, and improve taxpayer service.

The IRS has taken several steps to interact with industry to collaborate and discuss options for improved and lower cost taxpayer tax services. Weekly stakeholder calls during tax season and other topic specific calls and meetings have led to an improved dialogue and collaboration on tax services development. Attention and efforts should be continued and expanded. ETAAC continues to recommend these actions within this report.

## 3 EMERGING ENVIRONMENT AND CHALLENGES

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The United States self-assessment and voluntary compliance tax system has long been acknowledged as one of the premier revenue collection and management systems in the world. By its very definition, it must be all things to all taxpayers. Even though the primary objective of the tax system is to identify and collect taxes owed, the tax system also serves other purposes beyond the instant objectives of tax law compliance and revenue collection. Our political leaders have long leveraged the tax system and the tax return process as a critical economic policy tool to manage and improve the broader economic health and security of the country.

From Earned Income Tax Credits and Education Tax Credits to New Home Buyer Tax Credits and Taxpayer Stimulus payments, the tax laws and infrastructure have been used to motivate and stimulate areas needing support and equity. It has always been so and is likely to continue and increase. Within the backdrop of broad economic influence are many factors likely to lead to challenges in the future and, at a minimum, must be taken into account for future IRS strategic planning and implication.

The IRS current strategic plan has recognized six major trends creating issues and opportunities over the next year per the IRS Strategic Plan, IRS publication 3744. In prior years, ETAAC has commented on these and included additional considerations as with Tax Reform, Budgetary Challenges, and ever increasing taxpayer service expectations. ETAAC continues to believe all of those issues are relevant and impactful on the tax system and include three additional considerations this year.

### 3.1 LATE BREAKING TAX LEGISLATION

Each year it seems there are more sweeping tax law changes taking place later and later in the fiscal year. Even though much of the legislation is well intentioned and typically beneficial to taxpayers, the lateness in the calendar year, combined with the complexity of the changes and the overall system, present challenges to the entire tax system. The current and upcoming tax years are shaping up to be the perfect environment for late and complex legislation.

Late tax law changes are difficult to administer effectively let alone efficiently. It is a time-consuming process for the IRS to update systems and tax forms, for states to do the same, for software developers to create and test new tax software programs and to train and educate tax return preparers on the new rules. Finally, awareness by taxpayers of the tax changes and benefits can be lost with last minute tax law changes.

The continued practice of legislating late tax law changes, and in many cases retroactively to the start of a tax year and the consequent implementation of those changes, will increasingly undermine the efficiency and effectiveness of those changes, regardless of how well intended. ETAAC renews its support for bipartisan focus on longer-term strategic changes including simplification to better administer annual tax law changes.

### 3.2 GROWTH AND PROLIFERATION OF TAX FRAUD

The federal government is facing a future of increasing abuse and misuse of the tax system through tax fraud, identity theft, and other uses of taxpayer information for illegal gains. In addition to scope and volume are increases in complexity and sophistication of schemes. This increasing fraud and system misuse serves to undermine not only confidence in the tax system but also can bolster relaxation on the issue – an “everybody is doing it” mindset. IRS is acutely aware of the issue and making great strides to develop fraud detection and prevention systems and build on the broad experience they have, including this year’s MeF system and improved issue detection elements.

The focus should remain on issue prevention and detection, but an increased emphasis should be placed on enforcement and accountability. With increased enforcement and punishment to both taxpayers and professional tax preparers where applicable, in conjunction with prevention and detection, the return on investment of misuse of the tax system will be less attractive.

### 3.3 REAL TIME TAX SYSTEM

There has been much discussion and deliberation regarding the Real-Time Tax System concept for the future. The IRS could match information submitted on a tax return or provide detailed third-party information to a taxpayer at the beginning of return preparation and processing and provide the opportunity for taxpayers or tax preparers to fix the tax return in the event it contains data not matching IRS records. While conceptually the idea of advanced tax return perfection makes a great deal of sense and ETAAC supports the idea of faster, more accurate data, and convenience, the committee encourages continued dialogue on the subject. For many reasons including potential earlier filing requirements for businesses to submit taxpayer data to IRS, implications of continually late enacted tax legislation and overall tax rule complexity, the need for continued dialogue and tax industry and taxpayer involvement is needed. The potential benefits of access to earlier taxpayer data and “real time” taxpayer and tax return filing information are significant. From improved tax administration including greater accuracy and compliance, taxpayer service delivery and convenience, and tax return problem prevention, the positive elements are compelling and should be pursued.

## 4 ETAAC 2012 RECOMMENDATIONS

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ETAAC believes the IRS is at a point of great self-determination as it relates to successful administration of the tax laws of this country. To continue the great history of service and tax administration long established by the IRS, future considerations should include some or all of the following recommendations.

First, IRS must ensure taxpayers have confidence in the security, privacy, accuracy, and reliability of the tax system. To do this IRS needs to establish standards and practices to reinforce and make uniform many of the current best practices that the best and brightest industry participants use.

Second, even though the electronic filing participation rate for individuals has reached a long targeted goal of 80%, broader consideration for the remaining major return types and overall confidence in electronic filing must be maintained and grown in order to achieve true electronic filing success and the numerous compliance and economic benefits that will result.

Third, taxpayers have come to expect technology services, tools, and resources to be state of the art, current, convenient, reliable, and useful. As tax preparers continue to service the majority of taxpayer needs, state of the art tax administration tools and resources should be expanded and refined to quickly and efficiently serve those needs and can have an exponential multiplier effect for any advances in IRS provided tools and support.

Fourth, as the IRS will continue to be challenged to deliver more and greater service in a resource-constrained environment, IRS should look to the private sector for collaboration and delivery of select services and to provide for the needs and wants of the taxpaying community

Finally, MeF and CADE 2 among other IRS modernization efforts should be evaluated and refined for lessons learned with the recent implementation and future efforts to maximize the utilization of these new and powerful systems.

ETAAC's 2012 recommendations align with and enable these key outcomes.

***Key Outcome 1: Reinforce tax industry software technology and infrastructure standards regarding security, privacy, fraud prevention, and e-authentication to promote and safeguard taxpayer data and confidence in the tax system.***

**Recommendation 1:** IRS should publish, promote, and educate on appropriate and scalable standards for the electronic tax community regarding taxpayer data security and focus on industry implementation of these standards.

**Recommendation 2:** IRS should continue leveraging its leadership position regarding privacy protections by fostering greater awareness, disseminating scalable suggestions to the practitioner community, and continue promoting an internal privacy paradigm protecting all stakeholders.

**Recommendation 3:** The IRS should continue to examine alternative ways to provide proactive refund fraud discovery and prevention, including engaging industry for collaboration.

**Recommendation 4:** IRS should continue to work with other Federal Government agencies under the leadership of the Federal Chief Information Officers (CIO) Council and the appropriate governing bodies to develop electronic services that meet federal security requirements and taxpayer needs and expectations.

**Key Outcome 2:** *Continue the focus on the growth, improvement, and consistency of 80% electronic filing goal on the IRS major return types.*

**Recommendation 5:** IRS should form a service wide team comprised of an executive team leader and subject matter experts in communications and outreach, to include efforts to increase awareness of the ability to electronically file employment tax returns, primarily the 94x series, to remove barriers, and make electronic filing the preferred filing method.

**Recommendation 6:** IRS should focus on information returns and increased promotion and preferred electronic administration by expanding access to the IRS Taxpayer Identification Number (TIN) matching program; revising electronic filing guidelines for information return reports; increasing penalties for manually filed information return reports; and expanding outreach efforts to understand and eliminate barriers to electronic filing.

**Key Outcome 3:** *Empower taxpayers and tax return preparers and effect more accurate tax returns through effective delivery of taxpayer services through the internet and established tax industry relationships.*

**Recommendation 7:** IRS should increase and expand taxpayers' access to the specific tax information associated with their tax account at the IRS and other collateral information necessary to electronically file tax returns. IRS should make this information available using internet-based tools taxpayers can use real-time on an all-day every-day basis.

**Recommendation 8:** IRS should leverage its relationships with tax return preparers and tax software publishers providing additional secure access to taxpayer client information and collateral information to assist electronic filing, tax administration, and tax issue resolution assisted by the tax preparer community.

**Key Outcome 4:** *Leverage tax service delivery channels from the private sector with tax software developers and tax preparation companies to enhance and improve tax service delivery and thereby confidence in the overall electronic tax system by partnering and collaborating more.*

**Recommendation 9:** The IRS should continue periodic and ad hoc industry calls to exchange information and developments as well as host and participate in relevant tax technology and preparation industry conferences to facilitate taxpayer services development and tax administration strategic development.

**Recommendation 10:** Congress should recognize the negative effects to taxpayers and tax industry stakeholders of late year implemented tax legislation, and the IRS should develop a change management plan to help the tax preparation community deal with the likelihood of late legislative changes to the tax code making an impact on the 2013 tax season and successive years.

**Key Outcome 5:** *Congress should continue to fund the Modernization Program which includes Modernized e-file (MeF) and the Customer Account Data Engine (CADE 2), which will allow the IRS to continue to focus on the final implementation of MeF and CADE 2 while maintaining Legacy another year as a contingency.*

**Recommendation 11:** For the upcoming processing season, IRS should continue to work with stakeholders, including states and industry partners, to refine the full transition to MeF including a safeguard system using the Legacy platform.

**Recommendation 12:** IRS should continue to work towards the completion of the CADE 2 system to ensure implementation and transition to the relational database stays on schedule.

The remainder of this report provides ETAAC's summary and detailed recommendations and its supporting assessment.

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## KEY OUTCOME 1

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# Tax Software, Technology, and Infrastructure: Security, Privacy, and Reliability

**Key Outcome 1:** Reinforce tax industry software technology and infrastructure standards regarding security, privacy, fraud prevention, and e-authentication to promote and safeguard taxpayer data and confidence in the tax system.

**Recommendation 1:** IRS should publish, promote, and educate on appropriate and scalable standards for the electronic tax community regarding taxpayer data security and focus on industry implementation of these standards.

### Enhance Electronic Tax Data Security

ETAAC recommends the IRS take the following steps to enhance security throughout the return creation and filing cycle for both self-prepared and professionally prepared returns:

- Implement previous recommendations<sup>5</sup> regarding “digital infrastructure” including recommended security controls, a balanced assessment strategy, oversight of implementation and success rates, supported by an education process with phased and prioritized roll-out.
- Work with software companies and practitioner groups to develop and implement best practices regarding user access controls, data encryption, penetration testing methods, and data storage and retention.

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### Detailed Recommendations

#### E-File Security

To bring greater clarity and assurance to the security requirements for certain Authorized IRS e-file providers, ETAAC previously recommended the IRS take the following steps with respect to the e-file participants comprising the “digital infrastructure”<sup>6</sup> of the IRS electronic filing program handling individual and business income tax returns:

- Standards: IRS should supplement the guidance provided by the FTC Safeguards Rule by requiring the implementation of certain NIST SP 800-53 security controls<sup>7</sup> specified in the detailed recommendations of the Security Working Group of the ETAAC Software Subcommittee.
- Assessment: Consistent with other IRS security programs, IRS should require annual self-assessments, supplemented by independent third party assessments every three years<sup>8</sup> conducted by commercial third party security experts.

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5 The full report and recommendations of the Security Working Group of the ETAAC Software Subcommittee are available in the GSA FACA database for the ETAAC Public Meeting on June 15, 2011, and should be consulted. See <http://www.facadatabase.gov/committeemenu.asp?CID=76687>

6 The “digital infrastructure” refers to the e-file providers designated as transmitters, software developers, and online providers.

7 Other than the adoption of certain specified NIST SP 800-53 security controls, nothing in the Working Group’s recommendations should be understood to recommend the broader application of FISMA requirements to industry.

8 Other than the adoption of certain specified NIST SP 800-53 security controls, nothing in the Working Group’s recommendations should be understood to recommend the broader application of FISMA requirements to industry.

- **Implementation:** In implementing the above recommendations, IRS should:
  - Develop and implement any guidance and standards consistent with the guiding principles provided by ETAAC.
  - Phase-in the effectiveness of any new guidance and requirements over a two to three year period, although certain steps could be taken immediately to enhance industry security practices and IRS oversight.

### ***Tax Data Security Management***

ETAAC recommends the IRS and industry work together to form a focus group to determine standards based on best practices currently used in industry and government that will safeguard taxpayer data in all phases of the return preparation and filing process. The focus group could be an extension or subgroup of the current ETAAC group and could include comments in next year's report or in a separate report to IRS. Examples for possible considerations include:

- User password identification – Standardization of best practices and education to support utilization by software users.
- Data encryption – Paid preparers in particular operate systems where taxpayer data is collected and stored. Protection of that data should be supported both by commercial tax software built-in data management and computer hard drive encryption.
- Penetration testing – As more firms and individuals involved in the tax preparation process move to electronic and paperless processes, utilization of protective tools must be viewed as an issue for all industry partners operating as trusted partners interacting with the IRS in electronic tax administration. For large scale handlers of data, such as the “digital infrastructure” participants, this might include vulnerability analysis and penetration testing. At the smaller end of the scale, individual tax preparers could be encouraged in the direction of off the shelf standard best practices for small computer and network protection practices.
- Data back-up, storage, and retention – Practitioners interacting with the IRS who are transitioning to increasing electronic methods of electronic tax administration need to have clear understandings of their responsibilities for storage of that data. As with long-standing practices around paper records storage and retention policies and practices, transition of those to the electronic environment must be appropriately adapted.

**Recommendation 2:** IRS should continue leveraging its leadership position regarding privacy protections by fostering greater awareness, disseminating scalable suggestions to the practitioner community, and continue promoting an internal privacy paradigm protecting all stakeholders.

### ***Promote Privacy Education and Awareness***

ETAAC recommends the IRS should initiate and promote greater understanding of privacy-related issues by: creating greater awareness of the distinction practitioners should understand, and the separate considerations practitioners should have for privacy vs. security related matters; suggest some immediate and cost effective best practices on privacy protection, utilizing IRS news releases, reference material and trade outlets.

### ***Disseminate Effective Privacy Controls***

ETAAC recommends IRS use its leadership position to disseminate or assist in disseminating cost-effective, scalable, and uniform privacy controls such as: acceptance of a policy for disclosure of data breaches and privacy lapses and standardizing privacy statement content; integrate a “privacy self-assessment,” alongside the “security self-assessment” recommendation noted in the 2010, “Security

*Working Group of the ETAAC Software Subcommittee Report*” and, actively partner in a 2013 ETAAC industry survey of best Privacy practices for the solicitation of newly scalable tax practitioner Privacy controls.

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## Detailed Recommendations

### **Privacy Education and Awareness**

Privacy related issues have far ranging implications regarding confidence in the tax system and in particular with regard to electronic tax transactions. The IRS has an obvious leadership role in the privacy arena and is uniquely positioned to advance and foster a greater understanding of privacy-related matters to practitioners and among those whom they serve; the taxpaying public.

A recent White House report regarding consumer data privacy concerns underscores the importance not only in maintaining privacy – protecting an individual claim to the use of their information, but in distinguishing between both privacy and security as disparate topics. This distinction can benefit consumers, but more specifically, the entire tax community of stakeholders. The IRS, through both written and oral communications, must drive home the privacy versus security distinction.

The *Consumer Data Privacy in a Networked World* Report noted:

*“Privacy protections are critical to maintaining consumer trust in networked technologies. When consumers provide information about themselves—whether it is in the context of an online social network that is open to public view or a transaction involving sensitive personal data—they reasonably expect companies to use this information in ways that are consistent with the surrounding context. Many companies live up to these expectations, but some do not. Neither consumers nor companies have a clear set of ground rules to apply in the commercial arena. As a result it is difficult today for consumers to assess whether a company’s privacy practices warrant their trust”<sup>9</sup>*

Nearly 80% of all 1040 series tax returns are presently e-filed in the United States.<sup>10</sup> A privacy breach, separate and distinct from a security breach, which threatens or compromises the existing privacy safeguards inherent in our tax filing system could ultimately threaten the future stability of the entire tax system.

ETAAC has clearly understood and delineated privacy matters from security considerations. However, security has been discussed in separate detail by ETAAC through its previously released Working-Group Report.<sup>11</sup> Furthermore, the security topic is addressed in a subsequent section of the current, *2012 ETAAC Report to Congress*.<sup>12</sup>

While ETAAC has maintained a privacy and security distinction, in prior reports some confusion remains about where privacy and security issues diverge. Privacy does, in fact partially intersect in security matters including the concepts of appropriate use, as well as protection, of information. Where these

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9 “Consumer Data Privacy in a Networked World” White House Report, Feb. 2012

10 Source: IRS Publication 6186

11 The full report and recommendations of the Security Working Group of the ETAAC Software Subcommittee are available in the GSA FACA database for the ETAAC Public Meeting on June 15, 2011, and should be consulted.  
See <http://www.facadatabase.gov/committeemenu.asp?CID=76687>

12 Present report: Key Outcome 1

topics diverge is that privacy is essentially the *individual* claim to control those aspects of one's background they wish not to be disclosed or, conversely, a right to be left alone.

The threats to stakeholder privacy are unparalleled in today's electronic environment and of special risk with IRS due to the enormous volume and sensitivity of data maintained. The need for clear and strategic planning regarding data privacy aligned with security considerations are of particular importance and will only grow to be more important as more data is available online.

Privacy, as a distinct ETAAC report topic is supported by the prior work of the ETAAC Working-Group:

*"The Working Group was created pursuant to an ETAAC subcommittee charter effective September 1, 2009 (the "Charter"), in recognition that "The development and implementation of Information security and privacy policies, programs, and procedures for Authorized IRS e-file Providers is an integral part of the IRS' strategy for electronic tax administration and is currently one of the most pressing issues faced by the ETA".<sup>13</sup>*

The IRS can take a lead role in privacy outreach, to the practitioner community, due to the credibility IRS possesses with the stakeholder community. IRS credibility can be leveraged for the advancement of new and impactful measures that can be scalable to all practitioners.

One possible consideration or basic measure whereby IRS can immediately leverage its strengths to support privacy outreach might include use of IRS news releases such as, *FS-2012-5, January 2012*<sup>14</sup> highlighting privacy considerations, as an additional consideration the public should evaluate in hiring a tax professional. The IRS has many outlets and access to distribution networks for disseminating its news releases such as those mentioned. These press releases are a useful tool the IRS could utilize to raise awareness and to educate the tax paying public. IRS, through ETAAC and its support groups, can internally identify three to five examples of suggested questions taxpayers can ask of their preparers. These questions can be disseminated via the news release.

Fostering a focus on privacy may positively impact IRS in areas such as identity theft and refund fraud. Once a privacy channel is initiated among stakeholders, additional privacy recommendations could cascade between individual practitioners and the trade groups or may originate from IRS out to the stakeholder parties. Initial privacy-related concepts may include periodic reminders to repetitiously perform basic security measures safeguarding privacy and suggested participation in events and activities that could coalesce around a community, "Privacy Awareness" campaign.

The Security Privacy Working Group report states certain high-level objectives for the Working Group were to be established including:

*"Review and discuss the industry standards and best practices, as well as the existing and proposed IRS policies regarding taxpayer information security and privacy (e.g., IRS Publication 1075)."*<sup>15</sup>

13 The full report and recommendations of the Security Working Group of the ETAAC Software Subcommittee are available in the GSA FACA database for the ETAAC Public Meeting on June 15, 2011, and should be consulted.

See <http://www.facadatabase.gov/committeemenu.asp?CID=76687>

14 FS-2012-5, January 2012, available at [www.irs.gov](http://www.irs.gov)

15 FS-2012-5, January 2012, available at [www.irs.gov](http://www.irs.gov)

This high-level objective suggests ETAAC may want to consider an industry survey, of the practitioner community, for the 2013 ETAAC Report. The survey would specifically reference those privacy controls firms have employed and the best practices gleaned from this cross-section of the stakeholder community. Suggestions regarding overall scalability of privacy controls would be requested. An industry survey for the 2013 ETAAC Report of practitioner firms on their best practices for privacy policies would request comment regarding receptivity concerning:

1. The viability of implementing scalable Privacy Impact Assessments (PIA). PIA's are used extensively by IRS for assessing privacy threats that may exist in any subsystem and for understanding key privacy system concepts.
2. The use of internal privacy self-assessments in conjunction with security-self-assessment.
3. Development of a new template for the practitioner community to use, regarding Privacy Statements, that incorporates the current *Graham, Leach, Bliley Act* (GLB) act and any current or anticipated changes to governmental standards.
4. A "Privacy and Security Awareness" campaign. Solicit feedback on the viability of using the various industry trade groups for heightening practitioner privacy awareness through a week of scheduled events. Solicit input on suggested events.
5. Other suggestions to be discussed through consultation with IRS and Industry.

**Recommendation 3:** The IRS should continue to examine alternative ways to provide proactive refund fraud discovery and prevention, including engaging industry for collaboration.

***Alternative Ways to provide Proactive Fraud Discovery***

The IRS should consider additional safeguards that can be implemented in the e-file system throughout the lifecycle of return processing as with taxpayer education and awareness, communication, and notification. These safeguards could help both with the identification of identity theft and with suspicious returns claiming overpayments. The entire lifecycle of return processing includes:

- Pre-Validation
- Real Time Return Processing
- Post Processing

***Electronic Fraud Detection System (EFDS)***

The EFDS system which filters suspicious refunds can have unintended consequences. When these occur, communication and notification is required to both the tax preparation industry and the taxpayers waiting on their refunds. Education about the EFDS filtering and the potential for refund delays should be provided to both tax preparers and tax filers. There should be processes established to ensure when refund delays are experienced that communications and notification processes are in place to ensure prompt and informed communications are shared in a timely manner with the tax preparer and taxpayer communities.

## Detailed Recommendations

### ***Alternative Ways to Provide Proactive Fraud Discovery***

Pre-validation of return processing identifying potential identity theft and suspicious overpayment returns.

While all Providers must be on the lookout for fraud and abuse in IRS e-file, due to sheer volume, EROs, in addition to CPAs and EAs must be meticulous while acting in their capacity as the first contact with taxpayers filing a return. “An ERO must be diligent in recognizing fraud and abuse, reporting it to the IRS, and preventing it when possible. Providers must cooperate with the IRS’ investigations by making available to the IRS upon request, information and documents related to returns with potential fraud or abuse. EROs can find additional information in the article “Reporting Fraud and Abuse within the IRS e-file Program.”<sup>16</sup>

The ‘digital infrastructure’ includes e-file providers who are transmitters, software developers, and online providers of tax software and filing services. These providers frequently have a level of visibility into how returns are being originated and patterns associated with the process and the resulting tax returns. There have been specific concerns raised by digital infrastructure participants about being able to compile income tax return fraud patterns.

There is confusion and concern regarding the latitude available, in various regulations, for the tax preparation and digital infrastructure communities to assist the IRS with fraudulent return identification. ETAAC recommends the IRS review the specific regulations regarding these important issues and seek out areas to provide greater clarity. The IRS should provide clear, unambiguous guidance regarding all of IRC §7216<sup>17</sup> and its associated sections in regards to what tax return preparers and e-file providers can and cannot do regarding the latitude available to help detect and report on identify fraud, and fraudulent and abusive returns.

There are several places in the e-file system where suspicious activity can be identified and reported to the IRS prior to e-filed returns being submitted. Contractors who specialize in this type of pattern recognition software could work with e-file providers or e-file providers themselves could develop these technologies. This would allow these new pre-validation filters concerning identity fraud and suspicious returns to be “flagged” for the IRS on returns claiming over payments identified by the tax e-file system as potentially fraudulent. This process could provide the IRS additional “markers” on the e-filed returns to be identified and subsequently evaluated by the IRS fraud filters for refund validation processing.

Income Tax refund fraud indicators show up in a number of places from the preparer community to the e-file providers. A natural “choke point,” to identify refund fraud, may be in the transmitter process. Only a small number of transmitters electronically file tax returns. Returns are funneled through as shown in Table 9. This “choke-point” would be a potentially significant place to perform fraudulent return patterning and data mining activities if allowed by the IRS.

<sup>16</sup> Reporting Fraud and Abuse Within the IRS E-file Program – See <http://www.irs.gov/compliance/enforcement/article/0,,id=106773,00.html>

<sup>17</sup> Internal Revenue Code §7216 is a criminal provision enacted by the U.S. Congress in 1971 that prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information - See <http://www.irs.gov/efile/article/0,,id=188398,00.html>

The table below depicts the number of total return transmitters supplied in the TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION Interim Results of the 2012 Filing Season March 30, 2012 Reference Number: 2012-40-036

**Table 9:** Comparison of MeF System Transmitters through March 7, 2012 Number of Transmitters

	2011	2012	% Change
<b>Total Return Transmitters</b>	45	72	<b>60%</b>
<b>Return Transmitters Participating in MeF:</b>			
Return Transmitters	20	38	<b>90%</b>
States	25	34	<b>36%</b>

***Post Processing: Identifying potential identity theft and suspicious overpayment returns.***

The IRS should look at other methods, techniques, and authorizations that can help the IRS engage in self-funded contract models allowing the IRS to engage the private Sector to combat Income Tax fraud and abuse without requiring new funding requests to Congress.

This U.S. Federal Government Program Legislation is known as Improper Payments Elimination and Recovery Act of 2010.<sup>18</sup> The IRS should allow the private sector to propose new fraud detection capabilities for use by the IRS to provide additional secure services to tax return processing. The IRS should broaden the Tax e-file system to include private sector companies who provide opportunities to participate in fraudulent and abusive return detection and to help identify improper payments sent out from the Treasury. These opportunities are supported by this legislation to allow the IRS to engage companies willing to fund these initiatives upfront and be paid only when the benefits of improper payment recovery are realized and measured (benefits funded contracting). Benefits Funded Contracting does not require appropriations upfront and is only paid by Savings and Recovery of otherwise lost income to the U.S. Treasury.

***Real-Time identifying potential identity theft and suspicious overpayment returns.***

Other U.S. Federal Agencies are trying new innovations with demonstration projects. These projects can allow the IRS to broaden the Tax e-file system even further to include private sector companies who provide opportunities to participate in real time fraudulent return detection during real time return processing and stop improper payments from being sent out from the Treasury. These opportunities are currently not supported by this legislation (Improper Payments Elimination and Recovery Act of 2010) so the IRS may consider asking for this change in legislation or requesting authority for a Pilot project such as Centers for Medicare & Medicaid Services (CMS)<sup>19</sup> has done in 2011.

<sup>18</sup> Improper Payments Elimination and Recovery Act of 2010

See [http://www.whitehouse.gov/sites/default/files/omb/financial/\\_improper/PL\\_111-204.pdf](http://www.whitehouse.gov/sites/default/files/omb/financial/_improper/PL_111-204.pdf)

<sup>19</sup> CMS ANNOUNCES NEW DEMONSTRATIONS TO HELP CURB IMPROPER MEDICARE, MEDICAID PAYMENTS

See <https://www.cms.gov/apps/media/press/factsheet.asp?Counter=4176> and OMB press release -

See <http://www.whitehouse.gov/the-press-office/2011/11/15/we-can-t-wait-agencies-cut-nearly-18-billion-improper-payments-announce->

Beginning on January 1, 2012, CMS will conduct demonstration projects to strengthen Medicare by aiming at eliminating fraud, waste, and abuse. Reductions in improper payments will help ensure the sound future of the Medicare Trust Fund and protect Medicare beneficiaries who depend upon it.

**Recovery Audit Prepayment Review:** The Recovery Audit Prepayment Review demonstration will allow Medicare Recovery Auditors (RACs) to review claims before they are paid to ensure the provider complied with all Medicare payment rules. The RACs will conduct prepayment reviews on certain types of claims that historically result in high rates of improper payments. These reviews will focus on seven states with high populations of fraud- and error-prone providers (FL, CA, MI, TX, NY, LA, IL) and four states with high claims volumes of short inpatient hospital stays (PA, OH, NC, MO) for a total of 11 states. This demonstration will also help lower the error rate by preventing improper payments rather than the traditional “pay and chase” methods of looking for improper payments after they have been made.

If the IRS is able to implement pilot projects under this legislation, or amend the legislation for future benefits, then the IRS could allow private sector companies to propose proactive fraud detection capabilities. These could be used by the IRS to provide additional secure services in real-time tax return processing, return validation processing, or to allow proactive identity theft and fraud detection. IRS can make use of third party identity management tools to break the reliance on SSN and name matching, to provide more accurate identity management. Proactive Benefits Funded Contracting does not require appropriations upfront and is only paid by Savings and Recovery of otherwise lost income to the U.S. Treasury.

### ***Electronic Fraud Detection System (EFDS)***

Improve upon current EFDS and Implement new Proactive Fraud Discovery activities to reduce the amount of refund fraud and be more proactive in the ability to stop refund fraud.

In IRS.gov news release IR-2012-13, Jan. 31, 2012 titled “Identity Theft Crackdown Sweeps Across the Nation; More than 200 Actions Taken In Past Week in 23 States” the IRS commented:

“The IRS also is taking a number of additional steps this tax season to prevent identity theft and detect refund fraud before it occurs. These efforts include designing new identity theft screening filters that will improve the IRS’s ability to spot false returns before they are processed and before a refund is issued, as well as expanded efforts to place identity theft indicators on taxpayer accounts to track and manage identity theft incidents.”

Some taxpayers who e-filed their tax returns early in the 2012 Filing Season experienced delays in receiving their tax refunds. The IRS indicated it had experienced problems with its filters established to identify fraud and with the program used by the MeF system to create output files using the accepted e-file tax return data other IRS systems need to continue with the processing of the tax return. Filters established to identify fraud were initially identifying taxpayers as having indicators of possible fraud, which resulted in the tax return being held for additional screening.

However, the IRS identified that these filters were incorrectly identifying some taxpayers. The IRS indicated that once they made necessary adjustments to these filters, the problem was corrected.

- **Education:** The IRS should begin an education process with the taxpayer and tax preparer communities about new fraud detection filters and capabilities (including the replacement of

EFDS by the new Return Review Program (RRP) in 2015) and the potential for refund delays on suspected fraudulent refunds. Include in the education and outreach program the vision the closer the IRS gets to real time returns validation with more comprehensive fraud filtering the paradigm of “get the refund out the door as fast as possible” may lessen because of the need to reduce refund fraud through the new capabilities of the fraud filters and detection systems.

- **Communications:** The IRS should improve communications to the taxpayer and tax preparer communities when new fraud filters and detection capabilities (including the replacement of EFDS by the new Return Review Program (RRP) in 2015) cause the delay of non-fraudulent refunds. The IRS has moved to a nightly processing operation and the new IRS communication processes must reflect communication in a daily and not weekly manner. The IRS should review lessons learned on communication issued from the 2012 processing year and apply these to the final two years of the EFDS system and incorporate them and build upon them as the IRS designs and develops these processes for the new RRP system beginning in 2015.

Table 10 indicates specific Income Tax Fraudulent returns and their associated attributes identified to date and supplied in the TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION Interim Results of the 2012 Filing Season March 30, 2012 Reference Number: 2012-40-036

**Table 10:** Fraudulent Returns and Refunds Identified and Stopped in Processing Years 2009–2011

Processing Year	Number of Fraudulent Refund Returns Identified	Number of Fraudulent Refund Returns Stopped	Amount of Fraudulent Refund Returns Identified	Amount of Fraudulent Refund Returns Stopped
2009	457,369	369,257	\$2,988,945,590	\$2,517,094,116
2010	971,511	881,303	\$7,300,996,194	\$6,931,931,314
2011	2,176,657	1,756,242	\$16,186,395,218	\$14,353,795,007

**Recommendation 4:** IRS should continue to work with other Federal Government agencies under the leadership of the Federal Chief Information Officers (CIO’s) Council and the appropriate governing bodies to develop electronic services that meet federal security requirements and taxpayer needs and expectations.

***Continue the current focus on standards***

ETAAC recommends IRS take the following steps to allow IRS electronic services to be implemented for both the Taxpayer and Tax Practitioner communities in a secure manner:

The IRS continues to work with other Federal Government agencies under the leadership of the Federal CIO Council<sup>20</sup> and the appropriate governing bodies and uses and develops electronic services that meet federal security requirements and implement the appropriate e-authentication and level of assurance for each electronic service initiative.

<sup>20</sup> Requirements for Accepting Externally-Issued Identity Credentials  
See [http://www.cio.gov/documents/OMBReqforAcceptingExternally\\_IssuedIdCred10-6-2011.pdf](http://www.cio.gov/documents/OMBReqforAcceptingExternally_IssuedIdCred10-6-2011.pdf)

Particular focus should be on the guidance of the Open Identity Solution Trust Frameworks for Identity, Credential, and Access Management (ICAM)<sup>21</sup> produced by the Federal CIO Council Information Security and Identity Management Committee. The establishment of these e-Authentication and Validation levels should comply with the National Strategy for Trusted Identities in Cyberspace (NSTIC).<sup>22</sup> NSTIC calls for an Identity Ecosystem “an online environment where individuals and organizations will be able to trust each other because they follow agreed upon standards to obtain and authenticate their digital identities.”

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## Detailed Recommendations

### ***e-Authentication and Validation***

Align the work of the IRS new electronic services and IRS.gov initiatives with the appropriate level of assurance as defined by the Federal Information Processing Standard 199 Risk/Impact Profiles under policy foundation OMB M04-04<sup>23</sup> and leverage ICAM policies and frameworks including NSTIC:

- **Identity, Credential, and Access Management:** It is in the Federal government’s and the IRS’s best interest to leverage industry resources whenever possible. To support E-Government activities Federal Identity, Credential, and Access Management (FICAM) aims to leverage industry based credentials citizens already have for other purposes. In order to ensure these credentials are trustworthy, the government requires processes to assess these credentialing processes against federal requirements as codified by OMB, National Institute of Standards and Technology (NIST), and General Services Administration (GSA). Industry-based frameworks to assess the trustworthiness of electronic credentials already exist and can be leveraged by the Federal government and the IRS. This approach enables a scalable model for extending identity assurance across a broad range of citizen and business needs. Trust Frameworks include requirements for the credentials and their issuance, as well as for auditing qualifications and processes.

Trust Framework Providers are private companies who have been certified by ICAM through an assessment and approval process that meets federal standards. These approved identity providers can be trusted and used by federal Relying Parties (RP’s), such as the IRS at a known level of assurance (LOA) comparable to one of the four OMB Levels of Assurance.

Included in the 2012 National Association of State Chief Information Officers (NASCIO) 2012 Advocacy Priorities<sup>24</sup> is “With more states moving services online, NASCIO supports the National Strategy for Trusted Identities in Cyberspace (NSTIC) that would create a voluntary identity ecosystem to make online transactions more secure, private, and more convenient. NSTIC would promote privacy-enhancing technologies. NSTIC offers a vision of the future where the private sector, civil societies, and the public sector collaborate to create the standards and policies needed for interoperable trusted credentials reducing identity theft and fraud.”

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21 Federal ICAM Trust Framework Provider Adoption Process posted on <http://www.IDmanagement.gov>

22 Online authentication of people and devices: the President’s Cyberspace Policy Review established trusted identities as a cornerstone of improved cybersecurity – See [http://www.whitehouse.gov/sites/default/files/rss\\_viewer/NSTICstrategy\\_041511.pdf](http://www.whitehouse.gov/sites/default/files/rss_viewer/NSTICstrategy_041511.pdf)

23 Identity Assurance Levels are described in OMB Memorandum 04-04, E-authentication Guidance for Federal Agencies, and NIST Special Publication 800-63, Electronic Authentication Guidance. See [http://www.whitehouse.gov/omb/memoranda\\_2004](http://www.whitehouse.gov/omb/memoranda_2004) and <http://csrc.nist.gov/publications/PubsSPs.html>.

24 (NASCIO) 2012 Advocacy Priorities – See [www.nascio.org/advocacy/current/NASCIO%202012%20Advocacy%20Priorities%20\(Final\).pdf](http://www.nascio.org/advocacy/current/NASCIO%202012%20Advocacy%20Priorities%20(Final).pdf)

- Higher Assurance Levels for Security: When it is determined by the IRS the use of higher assurance levels are required for a particular IRS e-service such as using a hard crypto token, a one-time password device, or a soft crypto token the IRS should rely upon and use the N.I.S.T Special Publication 800-63 technical guidance for its security policy foundation for these highly secure e-service applications. When accepting Level 3 cryptographic and Level 4 credentials (the types of enhanced security requiring physical security mechanisms), the IRS should follow the Federal Public Key Infrastructure requirements. The Federal Public Key Infrastructure (PKI) uses a security technique called Public Key Cryptography to authenticate users and data, protect the integrity of transmitted data, and ensure non-repudiation and confidentiality. Components of Federal PKI include the Federal Bridge Certification Authority and the Federal PKI Common Policy Framework.

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## KEY OUTCOME 2

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### ***Growth, Improvement, and Consistency of 80% Electronic Filing Goal on the IRS Major Return Types***

**Key Outcome 2:** *Continue to focus on the growth, improvement and consistency of 80% electronic filing goal on the IRS major return types*

**Recommendation 5:** IRS should form a service-wide team comprised of an executive team leader and subject matter experts in communications and outreach, to include efforts to increase awareness of the ability to electronically file employment tax returns, primarily the 94x series, to remove barriers, and make electronic filing the preferred filing method.

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#### Detailed Recommendations

##### ***Employment Tax Returns***

Employment tax returns (94x family of returns) continue to be the largest group of tax returns not being electronically filed. The IRS plans to migrate the 94x family of returns to MeF in 2014. Based on the fact electronic filing of the 94x family has not realized even a modest increase from 2010 volumes, the IRS should closely examine simply moving the existing process to a modernized infrastructure. IRS should consider taking this opportunity to improve the filing process with the transition to MeF. The current low adoption rate will not improve if the same application and filing process is transitioned in its current state. IRS should work closely with the filing communities to identify effective and efficient improvements to the current processes, and determine if these improvements can be incorporated into the move to MeF.

##### ***Increase Communication and Outreach***

###### Form a Focused Service Team

IRS should form a service-wide team comprised of leaders and subject matter experts in communications and outreach, as indicated in the 2011 IRS response to the ETAAC report. The communication and outreach should include efforts to increase awareness of the ability to electronically file employment tax returns, remove barriers, and make electronic filing the preferred filing method. Additionally, IRS should increase industry promotion of electronic filing, simplify the application and filing process, and investigate the most cost effective ways to increase Forms 94x e-file.

IRS should update the information on IRS.gov in the following areas:

- IRS.gov homepage
- The Newsroom
- Hot Topic
- Electronic Filing Options for Business Returns
- E-File for Large and Mid-Size Corporations
- Business e-file Partners
- Business e-file Providers
- Headliner
- Small Business and Self-Employed Community
- E-File for Business and Self-Employed Taxpayers
- Approved IRS e-file for Business Providers
- Service-wide Key Messages for Tax Professionals
- E-news and SSA/IRS Reporter

IRS should increase internal communications in the following areas:

- Outreach priorities
- Periodic IRWeb articles
  - BUN line article
  - News from the Business Units
  - Update on Key Agency Projects
  - Daily News

***IRS should consider incorporating improvements in the 94x filing process in conjunction with the transition to MeF***

The 2011 ETAAC Report to Congress provided detailed information on the challenges in increasing the volume of electronically filed 94x returns. IRS should closely examine the survey results of the 2011 ETAAC survey of the employment tax return filing community to determine if improvements can be incorporated in the 2014 move to MeF. These improvements can be both operational and technical in nature. ETAAC will continue to support these IRS efforts, and will work closely with the filing community and the IRS to identify cost-effective improvements to the 94x filing experience.

**Recommendation 6:** IRS should focus on information returns and increased promotion and preferred electronic administration by expanding access to the IRS TIN matching program; revising electronic filing guidelines for information return reports; increasing penalties for manually filed information return reports; and expanding outreach efforts to understand and eliminate barriers to electronic filing.

### **Information Returns**

2.6 billion information return reports are currently filed annually. This number will increase exponentially with regulatory initiatives such as Foreign Account Tax Compliance Act (FATCA), § 6050W merchant reporting, and cost basis reporting. The information return is a valuable tool in the IRS's tax compliance arsenal as it is a cost-effective means to foster voluntary compliance and enables the IRS to swiftly identify those taxpayers not correctly reporting income. However, the utility is premised on the IRS being able to effectively match the information return against an individual's return via the taxpayer identification number and name and run the matching process. To the extent information return reports either have errors or have to be scanned or otherwise manually entered into the IRS's systems, the benefits of the matching process are diminished. Therefore, in order to promote an increased real-time tax environment, the IRS should expand access to the IRS TIN matching program, revise information return electronic filing guidelines, increase penalties for manually filed returns, and expand outreach efforts to understand and eliminate barriers to electronic filing. By taking these key steps to increase the utility of the information return, the IRS will make significant strides in its efforts to move to a real-time tax system.

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## Detailed Recommendations

### ***Expand Access to the IRS TIN Matching System.***

The IRS should:

- Identify and eliminate unnecessary and burdensome requirements that are barriers to the IRS TIN matching registration and allow tax preparers to have access to the IRS TIN matching system.
- Incentivize the use of electronic tax certifications incorporating TIN matching by allowing documented evidence of TIN matching to be used as prima facie evidence of "reasonable cause" in seeking abatement of penalties associated with Name / TIN mismatches.
- Expand the current electronic Forms W-8 Memorandum of Understanding (MOU) process to cover electronic Forms W-9 on a stand-alone basis provided TIN matching is included in the functionality.
- Authorize utilization of TIN matching for all information return reports, not just those subject to backup withholding.

The premise behind information reporting is taxpayers are more likely to correctly report income if there is a validation process.<sup>25</sup> This validation process is based upon matching a taxpayer's name against their TIN through a social security number, employer identification number, international

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<sup>25</sup> OECD, Information Note: Withholding & Information Reporting Regimes for Small/Medium Sized Businesses and Self-Employed Taxpayers, 35, August 2009.

taxpayer identification number, and – in the future – a Foreign Financial Institution Employer Identification Number (FFI-EIN).<sup>26</sup>

The IRS currently offers the TIN Matching program available for the filers of certain Forms 1099.<sup>27</sup> The service is free to use; however the withholding agent itself must complete the exercise - tax preparers cannot themselves complete TIN matching.<sup>28</sup> This is a particular barrier for U.S. withholding agents located outside of the U.S. Further, the registration process is cumbersome, particularly for withholding agents with outsourced or offshore accounts payable functions.<sup>29</sup> The TIN matching registration process requires a withholding agent to designate an employee to register for the service. That employee must provide personal information – including name, address, social security number, and prior year adjusted gross income as reported on individual tax returns.<sup>30</sup> Once the employee registers, it takes several days for the IRS to issue and mail them a PIN used to finalize the registration process.<sup>31</sup> The necessity to provide such detailed personal information as (the employee's) adjusted gross income is a considerable barrier to getting withholding agents registered for this process. Similarly, this represents an insurmountable barrier for U.S. withholding agents located outside of the U.S. as employees typically do not have U.S. taxpayer identification numbers or file U.S. tax returns.

Now is a critical time for the IRS to provide increased access to the TIN matching system. As part of the FATCA regulations, withholding agents, both U.S. and foreign, will be required to verify a FFI's FFI-EIN, prior to treating them as a participating FFI under the FATCA regulations.<sup>32</sup> As part of determining how this process will be opened to foreign withholding agents as part of FATCA, the IRS should consider opportunities to further expand access for U.S. withholding agents filing Forms 1099. In order to eliminate barriers for foreign-based U.S. withholding agents, the IRS should investigate other mechanisms for registering such as transmittal control codes or an emailed PIN as opposed to the current PIN mailing process.

The IRS issues "B-Notices" to Withholding Agents when an information return includes a Name / TIN mismatch.<sup>33</sup> These mismatches are the result of vendors or other taxpayers completing the Form W-9 incorrectly given confusion between legal names and d/b/a names, changes in name, or poor record keeping on the part of the Withholding Agent. Each Name / TIN mismatch is followed by a penalty notice.<sup>34</sup> To request abatement of this penalty, a taxpayer must show reasonable cause, meaning the taxpayer acted in a reasonable manner and there were significant mitigating factors or events beyond the taxpayer's control.<sup>35</sup> The IRS can minimize the number of mismatches, thus facilitating the income matching process by encouraging the adoption of electronic tax certification solutions with embedded logic to capture potential incorrect responses and with embedded TIN matching. Allowing documented usage of these solutions to serve as prima facie evidence the taxpayer acted in a reasonable manner

26 IRC § 6109(a)(1) provides that any payer required to file an information return must include the payee's correct TIN. IRS § 6109(a)(2) requires the payee to furnish their correct TIN to the payer.

27 See IRS Pub. No. 2108A, On-Line Taxpayer Identification Number (TIN) Matching Program, July 2011. (The TIN Matching program is available to filers of 1099-B, 1099-DIV, 1099-INT, 1099-K, 1099-MISC, 1099-OID, and 1099-PATR).

28 *id.* at 4-5, 9 (TIN Matching is a free assistance tool developed by e-Services as a service to our customers).

29 *id.* (Application for the TIN Matching Program may be made after successful completion of the two-step e-Services registration process. Detailed information about how to register for e-Services and apply for TIN matching is available from: <https://la.www4.irs.gov/e-services/Registration/index.htm>).

30 See <https://la.www4.irs.gov/e-services/Registration/index.htm>.

31 *id.*

32 See Temp. Treas. Reg. § 1.1471-3(e)(3)(2012).

33 IRC. § 3406 (a)(1)(B); see also IRS Pub. No. 1281, Backup Withholding for Missing and Incorrect Name/TIN(s) at 7, February 2011.

34 *id.* at 7.

35 IRS Pub. No. 2108A, On-Line Taxpayer Identification Number (TIN) Matching Program at 7, July 2011.

will incentivize industry usage of these solutions while at the same time minimizing mismatches. In addition, the IRS could leverage this opportunity to encourage software vendors to implement electronic filing as part of the same suite of products.

One way to facilitate this would be using the IRS's current Memorandum of Understanding (MOU) process. The IRS currently issues MOUs for electronic Form W-8 systems certifying the IRS has reviewed the logic and Forms produced via the system are valid. The IRS will extend the MOU to Forms W-9 to the extent they are included in the electronic Form W-8 system; however the IRS will not currently issue an MOU for standalone electronic Form W-9 systems. Consequently, the IRS should consider expanding the MOU process to standalone electronic Form W-9 systems and have a TIN matching requirement as part of the MOU criteria (as is required with the MOU process for Electronic W-8 and W-9 systems). This would reduce the burden on the IRS since it will facilitate accurate, electronic forms submission expediting the income matching process.

Finally, the IRS currently only allows TIN matching with respect to those information return reports that carry backup withholding responsibilities.<sup>36</sup> This includes Forms 1099-B, 1099-DIV, 1099-INT, 1099-K, 1099-MISC, 1099-OID, and 1099-PATR. Expanding usage to all information return reports will facilitate timely matching of tax returns and income against information return reports as it will increase the accuracy of data.

Overall, expanding access to and incentivizing usage of the IRS TIN matching system will significantly further the IRS's goals of real time tax. In addition, it minimizes current IRS operational burdens by minimizing B-Notices, penalty notices, and associated follow-up and customer service.

### ***Revise Electronic Filing Guidelines for Information Return Reports***

The IRS should:

- Reduce the threshold for mandatory electronic filing from 250 forms to 75 forms.
- Mandate amended returns must be filed electronically if the original returns were filed electronically.
- Explore and consider an electronic "fill-in" and file form for small taxpayers.

The IRS issued regulations in January 2005 outlining the requirements for certain corporations to electronically file Forms 1120 and 1120-S returns with tax periods ending on or after December 31, 2005.<sup>37</sup> Treasury Decision T.D. 9363 extended that requirement to e-file to foreign corporations with tax years ending on or after December 31, 2008, assets of \$10 million or more, and filing 250 or more returns annually.<sup>38</sup> The Government Accountability Office (GAO) has cited this mandate as one key factor in the increase in preparer e-filing.<sup>39</sup> The GAO issued a recommendation in *Penalty Authority and Digitizing More Paper Return Data Could Increase Benefits, 2011*, to impose penalties upon preparers for failure to comply with RRA and subsequent mandates.<sup>40</sup>

36 IRC §§ 3406(a)(1)(A) and (B); see also IRS Rev. Proc. 2003-9; IRS Pub. No. 2108A, On-Line Taxpayer Identification Number (TIN) Matching Program at 3, July 2011.

37 IRC § 301.6011-(5)(a); see also 2007-49 I.R.B. 1084, December 2007.

38 See 2007-49 I.R.B. 1084, December 2007.

39 See GAO 12-33, *Penalty Authority and Digitizing More Paper Return Data Could Increase Benefits*, October 2011.

40 *id.*

Currently if taxpayers file more than 250 information return reports, they are required to file electronically.<sup>41</sup> A separate 250 threshold applies for amended returns.<sup>42</sup> Reducing this threshold to 75 returns will increase movement towards a real-time tax system, while being sensitive to the needs of small businesses lacking the necessary resources (either human or financial) to file electronically. Requiring amended returns be filed electronically is consistent with this approach. The withholding agent filing the return initially has already proven they have access to the necessary tools to file the original form electronically. Therefore mandating the amendment be filed electronically will not represent an increased burden on the withholding agent and will minimize the burden of scanning or otherwise manually entering this record traditionally falling on the IRS. In addition it will reduce the risk of error of multiple forms (at least one of which is incorrect) being registered for the taxpayer.

Finally, the IRS should explore and consider an electronic “fill in” and file functionality for small filers. This initiative would involve the creation of a fill-in Form 1099-MISC. A small filer, defined as one issuing fewer than 50 Forms 1099-MISC for a given calendar year, would be able to create a user account and then complete Forms 1099-MISC online and simultaneously file the Forms. In addition the IRS could further leverage this opportunity to TIN match the file preventing an incorrect filing. This would minimize costs for small taxpayers (e.g., purchasing Forms) and significantly increase the volume of electronic filings. In addition small filers would also welcome this as an opportunity to comply with widespread “green” initiatives. If development of such technology proves burdensome, the IRS should review the potential to allow specified information reporting tax software companies to develop and offer the functionality.

### ***Increase Penalties for Manually Filed Returns***

The IRS should increase penalties for manually filed returns to \$150 and correspondingly adjust the cap to \$2,250,000.

The current penalty for a Name / TIN mismatch is \$100 per form, capped at \$1,500,000 per legal entity.<sup>43</sup> Manually filed returns require significantly more effort for the IRS to process, as they must be scanned or otherwise manually entered into the IRS systems. If the IRS were to increase penalties to \$150 and correspondingly adjust the cap to \$2,250,000, for manually filed returns, this would incentivize taxpayer’s to file electronically. In addition, such an increase would also compensate for the additional burdens manual filing poses on the IRS.

### ***Expand Outreach Efforts to Understand and Eliminate Barriers to Electronic Filing***

The IRS should:

- Commission a survey of various information return filers to understand barriers to electronic filing.
- Designate a liaison for providing information return assistance to the business community.
- Designate a business “sponsor” to help identify barriers as well as raise awareness of electronic filing options.

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41 See generally IRS Rev. Proc. 2011-40; IRS Pub. No. 1220, Specifications for Filing Forms 1097, 1098, 1099, 3921, 3922, 5498, 8935 and W-2G Electronically, March 2012; IRS Pub. No. 1187, Specifications for Filing 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding at 4, November 2011.

42 Specifications for Filing 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding at 8, November 2011.

43 See IRC § 6721; IRS Pub. No. 1586, Reasonable Cause Regulations & Requirements for Missing and Incorrect Name/TINs, at 1-2, April 2012.

In order to better understand barriers to electronic filing, the IRS should commission a survey of various information return filers to understand barriers to electronic filing. ETAAC is more than willing to perform such a survey in the 2013 membership year. These survey results could then provide an action plan for future efforts. In addition, the IRS should also designate a liaison for providing information return assistance to the business community. This individual would serve as a single point of contact for the IRS to address issues relating to information returns and act as the focal point for pushing strategic needs and tactical issues related to growing the electronic filing of information returns. One of the liaison models in place at the IRS today such as Stakeholder Liaison or National Account Manager could serve as the placement for such a liaison. Finally, the IRS should explore options to designate an executive business “sponsor” who would be responsible for driving IRS organizational efforts and understanding of barriers to electronic filing facing the business community as well as raising the business community’s awareness of IRS outreach efforts with respect to electronic filing and TIN matching. This business sponsor should actively partner with ETAAC on the information return filer survey to help promote industry engagement.

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## KEY OUTCOME 3

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### Taxpayer and Tax Return Preparer Tools, Resources and Services

**Key Outcome 3: Empower taxpayers and tax return preparers and effect more accurate tax returns through effective delivery of taxpayer services through the internet and established tax industry relationships.**

**Recommendation 7:** IRS should increase and expand taxpayer's access to the specific tax information associated with their tax account at the IRS and other collateral information necessary to electronically file tax returns. IRS should make this information available using internet-based tools that taxpayers can use real-time on an all-day every-day basis.

#### ***Access to Information***

This recommendation is a repeat and enhancement of one appearing in the 2011 ETAAC report for data retrieval encouraging the IRS to leverage the capabilities and diversity of the electronic tax return preparation and filing industry to deliver taxpayer services better met through private sector innovation.

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#### Detailed Recommendations

This recommendation is a variation of a concept considered in prior years with *My IRS Account* previously considered by IRS but deferred for a variety of reasons, the least of which was economic limitations for creation and delivery of such a platform of information. The intent of the current ETAAC recommendation is to offer an alternative that mitigates some of the reasons the prior recommendation was deferred. The 2011 report suggested the IRS consult with the stakeholders to find an effective way to share information with those preparing tax returns and for IRS to defer further consideration of the Simple Return (IRS prepared and data populated return) unless and until the substance of the US tax code for individual taxpayers is radically simplified.

Though the IRS agreed with the intent of this recommendation it responded in comments to prior year recommendations "as result of the current budget climate, we are unable to pursue this recommendation." ETAAC's continuing effort to encourage electronic filing and make progress in the direction towards the real time tax system Commissioner Shulman detailed in April, 2011 (National Press Club), ETAAC is re-framing the prior year recommendation in a step approach. Now, rather than calling for discussions between stakeholders leading to a generational leap in tax processing, ETAAC recommends increased utilization of existing tools and technologies for improved taxpayer access and implementation of practices that may take us further down the road toward Data Retrieval.

The IRS is a leader in Government to Citizen interaction with their innovation in smart phone applications and web based services. This is evidenced by the 31% increase in IRS.gov visits from 2011

to 2012 and the 92.4% increase of the “Where’s My Refund?” service at IRS.gov. IRS’s smart phone application IRS2Go allows taxpayers to check the status of their tax refund and obtain helpful tax information on certain mobile devices. This application was deployed in January 2011 and had over 350,000 downloads in the 2011 calendar year.<sup>44</sup> The increase in demand of these online and electronic services suggests there is significant taxpayer demand for these services over the internet. To derive the greatest benefit from the investment in these tools, the Service must encourage the use of these tools by those preparing tax returns, either the taxpayers themselves or the tax return preparers.

Some tools can be syndicated or have their benefit duplicated in tax return preparation software. When these tools are made available in tax software, the taxpayer or tax return preparer has ready access to the data in such a way the information can be utilized by the taxpayer to meet a taxpayer service need at a reduced cost to the Service. By providing this information in more places than IRS.gov IRS can further shift assister-answered calls to less-costly automated tools as contemplated by the GAO.<sup>45</sup>

The “Where’s My Refund?” tool is a perfect example of a service capable of providing this benefit. This tool has seen a tremendous growth, up 92 % in 2012 from 2011 to over 80 million requests and up 165% from 2009.<sup>46</sup> ETAAC believes enhanced services such as “Where’s My Refund?” and other internet-based tools do provide additional capabilities to taxpayers, and are critical to IRS success in maintaining and improving electronic tax administration. Currently after a taxpayer learns his/her return has been accepted and he/she wants to know the expected refund date, he/she must make a choice as to how to contact the IRS to determine refund status. If this information was already available to taxpayers through an automated tool and communicated to them by their tax preparation software or their tax return preparer, it is reasonable to assume the IRS would experience lower volume of contact from taxpayers on the issue. Lower volume of contact should result in lower operational costs.

The IRS should provide proactive notification of all refund processing delays outside the windows the IRS has set for the tax processing season, including those that may be driven by new fraud filters. This proactive notification should be targeted at the tax refund filers and the tax preparer communities to inform taxpayers waiting on refunds that the IRS is experiencing delays and to inform them the IRS communications will be sent as soon as the problems are addressed and resolved.

In tax processing year 2012, there was a period of time with early e-filed refund returns when not all refunds were accounted for on the “Where’s My Refund?” application, even a number of days after the acknowledgement and receipt of the e-filed return was sent. Tax preparers indicate that this led some taxpayers to fear the IRS had not accepted their returns, even though their tax preparer had received an acknowledgment from the IRS. Although, the IRS posted an advisory on its site explaining if taxpayers received an acknowledgment their return was received by the IRS, “they can be assured that the IRS has the tax return even though ‘Where’s My Refund?’ does not reflect that.” This situation caused a significant amount of additional calls to both IRS call centers and tax preparers across the country.

In addition to refund status, there are a number of reasons taxpayers may choose to contact the IRS during the tax filing process before the return is accepted by the IRS. Many of these contacts are caused by error reject codes. Error reject codes occur after a return has been electronically transmitted to the

44 TIGTA Interim Results of the 2012 Filing Season, March 20, 2012, 2012-40-036

45 GAO Report to the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, GAO-12-566, Interim Results of 2012 Tax Filing Season and Summary of the Fiscal Year 2013 Budget Request

46 TIGTA Interim Results of the 2012 Filing Season, March 20, 2012, 2012-40-036

IRS, but the IRS determines in their prerefund checks there is an error and the IRS returns the filing to the taxpayer or tax return preparer for correction.<sup>47</sup>

IRS should consult with the tax preparation and software industry to determine points during the tax preparation process where taxpayers or return preparers are in need of information from the IRS in order to complete tax returns with the most accurate information being reported on those returns. The goal of this consultation should be to determine what applications could be added to the IRS website to reduce taxpayer burden. This past year because of an informal consultation, and potentially due to error reject codes in the 2011 filing season, the IRS implemented a tool for taxpayers to lookup their First-Time Homebuyer Credit and Repayment Requirements. More tools like this should be considered.

As the IRS determines the need for additional tools, it should make a security and or privacy assessment regarding how the tool should be accessed. In the case of “Where’s My Refund?” and the First-Time Homebuyer Credit tool, the IRS requires data the taxpayer can obtain from their filed tax return. Once this information is entered into the IRS tool, the IRS provides the requested information.

For more sensitive data, IRS already has in place mechanisms to provide secure or password protected access to certain information through its e-Services used by tax return preparers and employers. Through this password-protected tool, certain users already have access to a service when presented with a name and tax identification number will indicate the name and number match or they do not. One of the greatest burdens of e-file is a rejected return due to mismatched name and tax identification numbers. By leveraging this tool or other similar data verification resource during the tax preparation process, tax preparation software could alert taxpayers or tax return preparers in real-time of the risk IRS will reject the return after submission, in order for the return to be perfected pre-submission. In this example, there is an opportunity for IRS to share information with the return preparer or taxpayer. The IRS will share the information once the return is filed having an effect of reducing error reject codes and possibly reducing IRS costs by minimizing telephone or other contact to the IRS. It is important to note use of the tool does not create any additional disclosure than in the current processing environment.

In the short term, the IRS should investigate what if any technical modification is required so that it can utilize its existing tool framework to make the tools available to more taxpayers, return preparers, and software developers. IRS may find, instead of a technology change, it is a mindset change that creates a proactive approach to generating a tax return rather than a reactive situation creating additional burden and cost to the IRS, the taxpayer, and other stakeholders through additional contact after the return is initially filed and potentially rejected.

Today, for example, most tax return preparers are registered users of e-Services and can use the name and taxpayer identification number (TIN) matching service for the issuing of Forms W-2 and 1099, but under current rules for use of the TIN matching system they are prohibited from using it for the preparation of a personal income tax return. Since the resources are there, IRS should benefit from its investment in those tools.

IRS should determine what resources can be devoted to ensure as changes are made to the tools that these changes are propagated to stakeholders. IRS will also need to generate a best practices document that can be used by those propagating IRS provided information such that the authoritative IRS

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47 GAO Testimony Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, GAO-11-691T. TAX REFUNDS Enhanced Prerefund Compliance Checks Could Yield Significant Benefits

information is accurately communicated. ETAAC agrees with the GAO recommendation from December 2011 in GAO-12-176 that IRS should finalize a strategy for determining which self-service tools to provide on its website.

In the future, IRS should consider a framework or architecture development for the use of tools by stakeholders. A long-term strategy needs to be in place for design of future tools and services as mentioned in the previous section. As the requirements are drafted for the internet-facing service, at the same time a computer-to-computer interaction, as was demonstrated by the Modernized e-file, should be contemplated for the dissemination of the data.

As is discussed many other places in the report, making a service available to the taxpayer is desirable, but consider the benefit of additionally enabling 700,000 tax return preparers who interact with over 100,000,000 taxpayers. By providing access to additional service delivery tools, options and alternatives for the less than 100 software companies developing tax preparation software and services, IRS could reach over 95% of taxpayers and benefit from the network of contact from the private tax industry.

Understanding the above concepts are considerable in value and taxpayer benefit, they are also complex and can be costly and increase resource demand. An early step in the consideration for any taxpayer collateral information platform should include an evaluation and study of information to be provided and the most economical means to deliver it. A cost benefit and return on investment study to identify the areas of highest return and corresponding effort should be considered.

**Recommendation 8:** IRS should leverage its relationships with tax return preparers and tax software publishers providing additional secure access to taxpayer client information and collateral information to assist electronic filing, tax administration, and tax issue resolution assisted by the tax preparer community.

### ***Leverage Relationships***

IRS must leverage its relationships with tax return preparers and tax software publishers encouraging them to use internet-based tools and to make them available to the taxpayers using their services. Utilizing these channels, IRS will have a much greater impact and realize a more widespread adoption than if they market to individuals.

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### **Detailed Recommendations**

In order to develop electronic tax filing, IRS engaged the private industry to work together to bring in tax returns electronically. Without the private industry delivery channel IRS has for its products and services, e-file would not be available to as many taxpayers as it is today.

To succeed at taxpayer service, IRS must again leverage the private industry innovation and delivery channels to provide higher quality service at a lower cost. A recent TIGTA report indicated the IRS anticipates being unable to handle a higher volume of incoming telephone calls. Understanding and exercising this Tax Eco-system Multiplier Effect allows the IRS to be more efficient; i.e. do more with less.

There are still many opportunities to build tools and process returns in a manner leveraging the wholesale approach to reaching taxpayers.<sup>48</sup> When the paid preparer community is better leveraged and can provide better tools to their customers, tens to hundreds of taxpayers realize the benefits simultaneously and quickly rather than one by one spread over a long period.

Currently over 95,000,000 million returns are prepared by paid preparers which include the reporting of 5.7 trillion dollars of income.<sup>49</sup> These numbers are significant. When the preparation industry is engaged and services and tools are built to help them assist and guide their customers, the volume of support the IRS is forced to administer independently can be significantly reduced.

There are many examples in government, both at the IRS and in other agencies, where service is increased exponentially by utilizing the multiplier effect. For example, the IRS Criminal Investigation unit is partnering with financial institutions and local law enforcement agencies to combat identity theft on a macro level.

ETAAC strongly encourages the IRS to collaborate and partner with the tax preparation and software industry on the tools recommended later in the ETAAC report. These types of partnerships will help the IRS reach a broader number of taxpayers and expedite achieving valuable steps toward real time processing.

Rejects received while trying to electronically file a tax return continue to pose a problem for the IRS and taxpayers because they cause bottle-necks in tax return filing, discourage taxpayers from completing an e-filed return, add costs to tax return preparation, and decrease processing efficiencies for the IRS. Returns that reject must be corrected and resubmitted when possible. Resubmissions cause filing delays and create a negative taxpayer experience.

Error Reject Codes occur when tax return information is submitted to the IRS and the IRS determines the information for a number of reasons is not accurate. The IRS then sends the return back to the taxpayer or return preparer for revision and issues a reject code. In the legacy e-file system, this reject code could be issued as much as 48 hours after submission to the IRS, and in the modernized e-file system, it can be issued in as many as 2 hours (or more for state submissions). In most cases the taxpayer or tax return preparer has moved on to another task by the time any error reject codes are generated and returned to them.

This process is contrary to the contemporary thought of a real-time tax system where data is validated before the point of filing and is frustrating for taxpayers living in a real-time world, conditioned to have data validation done early and often.

The IRS and the tax industry should work together to reduce e-file rejects to alleviate these problems. The top ten rejects accounted for 57.64% of the rejects received in the 2011-filing season. In its 2011 Annual Report, ETAAC outlined potential outcomes resulting from attacking the root cause of these common rejects. These included growing taxpayer confidence in e-file and increasing ease of e-filing, which both lead to an increase in successfully e-filed returns.

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<sup>48</sup> See Commissioner Shulman's remarks at National Press Club, April 2012

<sup>49</sup> *id.*

If the IRS allows the tax industry to have access to IRS tools and resources to validate tax return information before transmitting a return, the industry could reduce the number of the most common errors producing rejects before transmission rather than after transmission.

Some of the tools that the industry would like access to include:

- Taxpayer prior year PIN or AGI lookup tool – Integrating the tools within the vendor software package would reduce the volume of self-prepared rejects, IND-031.
- Taxpayer Identification Number (TIN) matching - Name-control/SSN mismatch is one of the highest volume rejects. As indicated earlier, this tool is available to certain users in e-Services, but not available to tax return preparers.
- Dependent information validations.
- First Time Home Buyer's Credit tool – If made available to tax preparers would allow for more accurate repayment information to be entered on return.

ETAAC believes allowing industry access to some IRS tools will not only provide for more returns successfully transmitted on initial send resulting in improved taxpayer confidence and satisfaction with the e-file process, but it will also reduce the burden of taxpayer calls on the IRS. ETAAC continues to believe IRS should work with industry to identify, review, track, and publicly report on actions taken to reduce rejects.

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## KEY OUTCOME 4

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# ***Public Sector and Private Sector Partnering and Collaboration***

**Key Outcome 4:** Leverage tax service delivery channels from the private sector with tax software developers and tax preparation companies to enhance and improve tax service delivery and thereby confidence in the overall electronic tax system by partnering and collaborating more.

**Recommendation 9:** The IRS should continue periodic and ad hoc industry calls to exchange information and developments as well as host and participate in relevant tax technology and preparation industry conferences to facilitate taxpayer services development and tax administration strategic development.

The IRS throughout 2011 and into 2012 conducted several ad hoc industry calls with ETA Partners. These calls provided a way for the IRS to notify the transmitter community of scheduled maintenance and changes to the e-file transmission process such as the CADE 2 and refund processing schedule and changes to the submission processing of electronic files. The calls were also used to gather feedback and questions from the partner community. ETAAC strongly urges the IRS to continue these calls not only on an ad hoc basis, but also on a regular basis to solicit feedback from industry during all stages of the tax year processing cycle. This allows the IRS to gain feedback on real-time challenges industry partners are experiencing and work with the IRS to mitigate negative impacts to the taxpayer filing experience.

In 2011, a good example was the interaction between the IRS and the tax software vendors to communicate and set proper expectations for refund delivery due to additional processing of filters to detect fraud and identity theft of taxpayer data.<sup>50</sup> With the increased expectations of faster processing, it is very important the IRS work with the tax software and preparation community to inform taxpayers of any anticipated changes, particularly when reasonable background information is available so taxpayers understand and experience the customer service the IRS is striving to achieve.

ETAAC further recommends the IRS continues to host its Annual Software Developers Conference in 2012 and continues to present and participate in other tax technology conferences. This participation includes facilitation by the IRS to identify trends the preparation industry is witnessing, such as collecting information and having dialogue with participants on the top five things the IRS could do to drive down demand to the IRS call center. The preparation industry often receives calls prior to the taxpayers calling the IRS. Specifically, feedback from vendors regarding the types of issues vendors ultimately direct to the IRS and input regarding which issues have the largest positive improvement to the taxpayers' experience is valuable information for the IRS to collect. This type of engagement would help the IRS both strategically and tactically.

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<sup>50</sup> IRS Delays Refunds – See <http://abcnews.go.com/blogs/business/2012/01/morning-business-memo-irs-delays-refunds>

Two industry conferences the IRS participates in, and should continue to engage stakeholders, at are the Council for Electronic Revenue Communication Advancement, CERCA,<sup>51</sup> and the National Association of Computer Tax Processors, NACTP.<sup>52</sup> Both of these organizations not only conduct annual and seasonal events, but also work jointly with the IRS for specific meetings and engagement of stakeholders on an ad hoc basis.

Conducting industry calls, participating in industry conferences and hosting the annual software developers' conference enables the IRS to not only engage stakeholders for feedback, but also helps the IRS and industry to be consistent in their messaging and updates to the taxpayer community. Congress and the IRS by continuing to support these engagement activities are taking a good step to ensure taxpayer confidence is sustained and expectations met.

**Recommendation 10:** Congress should recognize the negative effects to taxpayers and tax industry stakeholders of late year implemented tax legislation and the IRS should develop a change management plan to help the tax preparation community deal with the likelihood of late legislative changes to the tax code making an impact the 2013 tax season and successive years.

In 2012, dozens of tax cuts are set to expire which could result in a frenzy of changes to tax forms and therefore legacy and modernized e-file schemas. When these types of changes occur, the entire tax ecosystem from governmental resources at Treasury and the IRS to tax software vendors, preparers, and taxpayers themselves are affected. Even when time to educate and adapt to the changes is available before a filing season, the cost to the stakeholders involved in learning about, understanding, adjusting processes, and filing returns is significant.

Recently a Senate Finance Committee<sup>53</sup> heard witnesses testify to the complexity of the current tax code. During testimony by an IRS deputy commissioner at this hearing, it was communicated that the IRS is already preparing for a year-end rush to accommodate last minute tax code additions or extenders anticipated from a lame-duck session of Congress that could also increase complexity.

ETAAC recognizes and applauds the IRS for their advanced preparation and recommends communication as proactively as possible of schedules related to delivery of forms, e-file schemas, filing system up and down times in both best and worst case scenarios so the industry can work with the IRS to set taxpayer expectations of the impact of late legislative changes. ETAAC also recommends IRS solicit feedback from its industry partners during an upcoming industry partner call addressing how the risks associated with late legislation and the electronic tax administration ecosystem can be mutually mitigated.

However, there are still many opportunities to build tools and process returns in a manner leveraging the wholesale<sup>54</sup> approach to reaching taxpayers. When the IRS works with and leverages the paid preparer community in order to provide them with tools to help their customers, the IRS reaches tens to hundreds of taxpayers at a time rather than one by one.

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51 See <http://www.cerca.org/>

52 See <http://www.nactp.org/>

53 Tax Simplification Tops Witness Wish List at Finance Committee Hearing, Tax Notes Today, April 27, 2012.

54 See Commissioner Shulman's remarks at National Press Club, April 2012

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## KEY OUTCOME 5

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### ***Modernization- MeF and CADE 2 and beyond***

**Key Outcome 5:** *Congress should continue to fund the Modernization Program which includes Modernized e-file (MeF) and the Customer Account Data Engine (CADE 2), which will allow the IRS to continue to focus on the final implementation of MeF and CADE 2 while maintaining Legacy another year as a contingency.*

**Recommendation 11:** For the upcoming processing season, IRS should continue to work with stakeholders, including states and industry partners, to refine the full transition to MeF including a safeguard system using the Legacy platform.

MeF is a Web-based system providing a more flexible electronic filing system.<sup>55</sup> MeF release 7.0, which was deployed in January 2012, brought 132 new forms to MeF platform compared to 23 forms in 2010 and 2011. IRS has reported 60% of all federal returns were processed through MeF with no major issues with MeF functionality. Approximately 48 million returns have gone through the Legacy system. Since transmitters were asked to switch to Legacy in February to transmit returns, MeF volume was less than anticipated. Some transmitters stayed with Legacy through the end of the filing season in lieu of moving back to MeF. IRS has stated they have reached a milestone of over 100 million returns since it began processing returns through the MeF system.<sup>56</sup>

Last year, because of ramp up strategy, many software companies were not providing state MeF but the tax industry has shown much progress in this area in 2012. Currently 35 states are participating in MeF, with the remaining eight states to be ready by January 2013. In December of 2012 the IRS instructed tax return processing companies transmitting 1 million or more 1040 e-filed returns (including all 1040 form family and F4868 extensions) during Filing Season 2011 that they will be required to process their 2012 e-file volume through MeF.<sup>57</sup> Transmitters did a very small amount of hub testing with the IRS in January leading up to e-file opening day, January 17, 2012.

ETAAC's June 2011 Annual Report to Congress recommended the IRS develop specific "shutdown conditions" for retiring Legacy after the 2012 filing season (tax year 2011), to ensure a successful transition. Given programming problems with MeF that caused delays in processing of returns early in the 2012 filing season, it is ETAAC's recommendation that IRS continue to maintain the Legacy system for the 2013 filing season and determine if Legacy will be retired after that. The GAO<sup>58</sup> and TIGTA<sup>59</sup> reports also address the risk of retiring Legacy in 2012 given the problems encountered this tax season.

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<sup>55</sup> June 2011 ETAAC Annual Report to Congress

<sup>56</sup> FTA E-file symposium; May 2012; St Louis, MO.

<sup>57</sup> See <http://www.irs.gov/efile/article/0,,id=220827,00.html>

<sup>58</sup> GAO Report: IRS Interim Results of 2012 Tax Filing Season and Summary of the Fiscal 2013 Budget Request, March 20, 2012

<sup>59</sup> TIGTA Interim Results of the 2012 Filing Season, March 20, 2012, 2012-40-036

The MeF system was down three times during the 2012 filing season. During the week of January 17 and January 26, 2012 a programming error caused delays of approximately six million returns.<sup>60</sup> On February 10, 2012 the IRS notified all of its stakeholders that an issue existed with processing tax returns and the system needed to be shut down a few days until the backlog could clear.<sup>61</sup> The IRS instructed the transmitters to send returns through the Legacy system while the IRS took care of the approximately 7.8 million tax returns affected by the programming issues.<sup>62</sup> Additionally, on April 16 the system went down for about an hour.

Since all states were not using the MeF system, there is no way to determine what the increased volume will have on the IRS system once all 43 states are on board. Given the number of tax returns affected by the problems described above there is a concern that the system has not been tested full strength. During the 2012 filing season, MeF had its challenges with processing issues including a number of states having backlog issues with state return retrievals.

### **State Participation**

One of the keys to the success of MeF is the programs top stakeholders – the states. It is vitally important to strengthen the partnership with the states during the final implementation of MeF.

States are extremely concerned with the contingency plan to use “federal only” filing on the Legacy system if the MeF system is not available. States have expressed concern and consider it premature to shut down Legacy since they have little faith that next year will improve. States have stated the IRS needs to realize states do not have resources to process paper even for a short period of time so large volume of paper is not feasible. They also feel that the IRS needs to focus on the gateway process as many states are still experiencing issues.

During the past filing season, select states encountered difficulties within the electronic processing system – for a variety of reasons including difficulties communicating with the IRS gateway to download returns. The IRS and states were unable to specifically diagnose the issue with the gateway. Given the fact many states were added to the MeF system during calendar year 2012, the volume of returns and data will increase greatly during the 2013-filing season. The states have stressed the need for the IRS to perform more volume testing. ETAAC recommends the IRS consider implementing a high volume test, including the states, prior to tax season to ensure MeF system will be able to handle the increased volume now that most, if not all, states have implemented MeF. If the state component is unavailable for a considerable length of time, there is no contingency in place.

If preparers and individuals are not able to file both federal and state returns together that may lead to frustration with the filing system. Increased frustration from preparers and individuals could lead to a reduction of returns filed electronically, therefore causing a setback in achieving the 80% e-file goal.

60 GAO Report March 2012; GAO 12-566; p 12

61 IRS QuickAlerts for Tax Professionals, February 10, 2012

62 GAO Report March 2012; GAO 12-566; p 13

### **IRS Transition to MeF**

IRS has stated only parts of Legacy will be maintained and will only be used as a catastrophic contingency. In a contingency or disaster issue, a subset of the 1040 forms (23 forms), would be available. These forms are considered to be 80% of e-file volume.

A complete transitioning to MeF is crucial to cut down on the cost of maintaining two e-file processing systems. ETAAC understands that there may be considerable costs to both IRS and Industry to maintain two systems. Nevertheless, ETAAC recommends transitioning should occur only after the system is tested with all states participating to ensure no issues due to volume will occur. ETAAC concurs with both GAO and TIGTA there is considerable risk in not offering the full legacy system for the 2013 processing year, and this risk can disrupt the attainment and retention of the 80% goal of e-filed returns.

ETAAC recommends IRS conduct post-mortem analysis and report to stakeholders and trading partners lessons learned, actions taken, and next steps. This analysis should take place before August 2012. This communication should occur during IRS/Industry meetings such as the Software Developer Conference and monthly IRS/Industry calls. This type of communication will help continue to build confidence in the system between the IRS and key stakeholders. ETAAC also recommends IRS create a working group to include stakeholders and trading partners to participate in the decision making process when determining when to retire the Legacy system. IRS should work with stakeholders when determining which parts will be maintained so no one is at a disadvantage or placed in a position of risk. This collaboration is necessary to boost taxpayer confidence in the e-file system.

Communication between IRS and stakeholders is vital not only during the tax filing season but should continue all year around. Communication should include planned and unplanned downtime, performance issues, and issue resolution response.

ETAAC's above recommendations to work with stakeholders during the transition to MeF is intended to build on the partnership and collaboration with industry, as well as build confidence with taxpayers and tax return preparers confirming e-file is the best way to file returns.

**Recommendation 12:** IRS should continue to work towards the completion of the Customer Account Data Engine 2 (CADE 2) system to ensure implementation and transition to the relational database stays on schedule.

The IRS is moving forward with its CADE 2 system implementation, which will result in a single relational database to house all individual taxpayer accounts in a central data source making reporting and retrieval faster and more efficient. The IRS indicates the CADE 2 system will result in timelier taxpayer data, increased analytical data stores, improved/increased tools to more effectively use data for compliance and customer service, and enhanced data security. This represents a new way of posting taxpayer data to the Individual Master File (Master File) for 2012. The IRS is changing from its decades

old method of posting tax data once a week to the ability to post tax data to the Master File daily. Certain transactions that may require additional review are identified up front and are still only posted once per week. The ability to post information to the Master File on a daily basis will enable the IRS to provide tax refunds to taxpayers more quickly.<sup>63</sup>

ETAAC believes a successful deployment of the CADE 2 program is critical to IRS' ability to meet taxpayer needs. During 2012 tax filing season (Tax Year 2011) the IRS Modernized e-file system experienced problems by creating incomplete and/or duplicate output files using the accepted e-file data. This resulted in delays in sending the output files to downstream processing systems. The programming problems delayed the processing of approximately 7.8 million tax returns.<sup>64</sup> This delay in processing led to the national news media covering the issue and public dissatisfaction of e-file.<sup>65</sup> While TIGTA identified the root cause of the delays to be the new Modernized e-file platform, any issues with the CADE 2 system can create similar issues. The IRS should carefully weigh the negative impact to taxpayer confidence in e-file and whole tax filing system developed in situations where tax returns are processed at slower rates than is expected based on prior performance or published materials and guidance.

IRS should work to establish messaging to the taxpayers and other trading partners regarding the availability of the benefits of CADE 2. The IRS should also communicate any issues regarding the implementation of or transition to the CADE 2 system. With effective messaging by the IRS and leveraging the relationships with tax return preparers and tax software publishers as contemplated in Key Outcome 3, the IRS will better set the expectations of taxpayers.

As in the 2011 and 2010 ETAAC reports, ETAAC continues to strongly encourage Congress to fully fund the IRS CADE 2 efforts and other modernization efforts. In the 2011 ETAAC report it was stated "In 2012, CADE 2 will deliver a single, authoritative relational database and daily updates from core taxpayer account processing applications with capabilities for faster refunds and enhanced services to all individual taxpayers."

As these modernized services become more available, IRS should clearly communicate to its trading partners including states and the tax preparation industry regarding the status of the transition to CADE 2. IRS should review new capabilities made available as a result of the CADE 2 and consider the development of additional tools for use by taxpayers and the tax preparation industry consistent with the other sections of this report.

63 TIGTA Interim Results of the 2012 Filing Season, March 20, 2012, 2012-40-036

64 TIGTA Interim Results of the 2012 Filing Season, March 20, 2012, 2012-40-036

65 See [http://www.irs.gov/pub/irs-utl/nta\\_testimony\\_idtheft\\_050812.pdf](http://www.irs.gov/pub/irs-utl/nta_testimony_idtheft_050812.pdf)

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## APPENDIX A: ETAAC MEMBERS

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**Timothy Blevins** – Mr. Blevins is the Chief Technology Officer with CGI's Tax, Revenue, and Collections Center of Excellence and is from Mayetta, KS. He is responsible for providing expertise to clients to enhance their tax operations and collections management systems. Mr. Blevins has over 30 years of experience in the implementation, management, and modernization efforts of government information technology solutions with the State of Kansas. He was CIO for Kansas SRS for five years and the Kansas Department of Revenue for 11 years. He earned a B.A. in Management Information Systems from Washburn University and is a former Co-Chair of the Federation of Tax Administrators-Internal Revenue Service Tactical Advisory Group (FTA-IRS TAG).

**Leann Boswell** – Ms. Boswell of Van Meter, IA, is an executive officer II for the Iowa Department of Revenue. She is responsible for the e-file Service Unit. Ms. Boswell led the development of e-file & Pay, for business tax electronic file and payment applications, reaching a voluntary adoption level of 97 per cent. She also facilitates e-file & Pay enhancements and problem resolution. Ms. Boswell earned a BS in Business Management and participates on a national committee to increase Free File participation.

**Sean J Brennan** – Mr. Brennan of West Chester, PA, is president of Brennan & Associates and Brennan and Company, CPA, PC. He is a CPA e-filing hundreds of individual and business tax returns and has taught numerous courses, at the college level, for the past 15 years. Mr. Brennan earned a BS in Accounting from St. Joseph's University and a MBA in Economics and Finance from West Chester University. Mr. Brennan is a member of the National Association of Tax Professionals and the American Institute of Certified Public Accountants (AICPA) and the Pennsylvania IRS/Practitioner Liaison Committee.

**Alice Burnett** – Ms. Burnett is the owner and president of Burnett and Associates, LLC from Lawrenceville, GA. Her company offers support to both public and private sector clients, primarily covering programs that contain a financial component. Prior to starting her own practice, Ms. Burnett held a senior manager level position within a major financial institution for over 20 years, and she was a manager for the implementation and operation of the Electronic Federal Tax Payment System (EFTPS). Certifications include Project Management Professional (PMP), BAI Certified Risk Professional in Operations, Certified Supplier Manager, and Six Sigma Green Belt. Ms. Burnett is a member of the Project Management Institute (PMI), American Management Association (AMA), and American Society for Quality (ASQ).

**Cyrus Daftary** – Mr. Daftary of Newton, MA, is a partner with Burt, Staples & Maner, LLP where he is responsible for consulting with multi-national corporations and financial institutions on their compliance in the IRS tax withholding and information return reporting rules. Mr. Daftary assists clients in obtaining a Memoranda of Understanding from the IRS for the electronic W-8 software application. His experience includes developing and implementing tax software solutions for withholding and information return reporting and authoring a three series treaty on E-Commerce.

**Ned Drinker** – Mr. Drinker is the tax manager of Oberthur Technologies of America Corporation and is from Conshohocken, PA. He is responsible for all US tax matters including preparation and e-filing of the federal income tax return as well as the preparation and filing of all state income/franchise tax returns. He manages federal and state audits, information reporting, tax depreciation and sales and use tax compliance. He has implemented sales tax software for diverse businesses. Mr. Drinker earned a B.A. in Economics from Hamilton College, an MBA in Econometrics from Temple University, and a Master of Taxation from Villanova University School of Law. He is a member of Tax Executives Institute and chairs the Philadelphia Chapter's IRS Administrative Affairs Committee.

**Yasmine (Mimi) Nolan** – Ms. Nolan is the director, Tax Forms Management with H&R Block from Parkville, MO. She oversees the centralized process of procurement, distribution, and interpretation of all tax regulatory changes, as well as tests tax law changes for regulatory accuracy across products. She is responsible for a team that procures tax documents, monitors and analyzes changes to the federal and state income tax forms, publications, instructions, and tax notices. Ms. Nolan has directed system, product design and implementation of digital tax preparation solutions. Her experience also includes electronic filing and tax software development, tax forms management, quality assurance in systems development, and tax preparation. Ms. Nolan earned a B.S. in Computer Based Information Systems from Park University and an MBA from University of Missouri-Kansas City. She is a member representative to National Association of Computerized Tax Processors (NATCP), and serves as Chairperson of the Government Liaison Committee.

**David Olsen** – Mr. Olsen of Kennesaw, GA, is a CPA and the director of product management for CCH Small Firm Services. He is responsible for product opportunity and enhancement planning for the ATX and Tax Wise product lines, covering tax, accounting and workflow software, and other supporting products. Mr. Olsen also partners with business development functions to analyze and develop proposals for products and services used by the tax community. He earned a BA in Business from Houghton College and is a member of the American Institute of Certified Public Accountants (AICPA).

**Douglas Simon** – Mr. Simon of Lincolnshire, IL, is president and founder of HS&A Payroll Services, Inc. He is responsible for a suite of tax compliance, payroll, and retirement plan solutions. Mr. Simon works with a wide range of companies and oversees both tax filing and compliance operations. Mr. Simon earned a BS in Electrical Engineering from Northwestern University and a MBA from DePaul Kellstadt Graduate School of Business. He is a member of the American Payroll Association (APA) and the Independent Payroll Association Providers.

**Mark A Steber** – Mr. Steber of Sarasota, FL, is a CPA and the chief tax officer for Jackson Hewitt Tax Service. He has over 24 years of experience in the tax industry. Mr. Steber oversees all processes and procedures to ensure the accuracy of tax returns prepared in the Jackson Hewitt system and coordinate the monitoring of each office's compliance. He is a frequent public speaker on tax issues and tax industry matters. He is a member of the American Institute of Certified Public Accountants (AICPA) and Alabama and Georgia Society of Certified Public Accountants

**David Sullivan** – Mr. Sullivan of East Greenwich, RI, is the Tax Administrator for the Rhode Island Division of Taxation. He is responsible for creating the E-government Unit to assist in enhancing and improving their interaction with customers using new technologies. He earned a BS in Accounting and Business Management from Lebanon Valley College and a MS in Taxation from Widener University. Prior memberships include Treasurer and President of the Northeastern State Tax Officials Association and Federation of Tax Administrators - Internal Revenue Service Tactical Advisory Group (FTA-IRS TAG).

**Timur Taluy** – Mr. Taluy of Oxnard, CA, is the chief executive officer of FileYourTaxes.com. He is responsible for the development of the user interface, the secure external interface, and tax intelligence platform. Taluy manages the development and enforcement of internal policies and controls regarding safeguarding and development of tax return data processing systems. He also oversees the process contributing to the accuracy of the final tax product. He is a member of Council for Electronic Revenue Communication Advancement.

**TJ Turner** – Mr. Turner of Cape Coral, FL, is a senior principal business system architect for Vertex Inc. He is responsible for leading software development of Vertex's enterprise corporate tax application product suite. Products include tax data warehouse, compliance, and tax accounting solutions across several tax domains. He has worked in the corporate tax technology industry for over 12 years, including roles consulting corporate taxpayers to adapt legislative and technology changes and leading research professionals responsible for creating and updating tax content for several tax applications. Mr. Turner earned a BA in Business Administration from Baldwin-Wallace College and has a JSM in International Tax and Finance from the Thomas Jefferson School of Law.

**Harris Widmer** – Mr. Widmer of Fargo, ND, is a CPA and partner in Widmer Roel PC. He provides tax, consulting, audit, and financial planning services to a wide variety of businesses and individual clients. Mr. Widmer earned a BA from Jamestown College. He is a member of the North Dakota Society of Certified Public Accountants, American Institute of Certified Public Accountants (AICPA), and National Association of State Oversight Boards of Accountancy.

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## APPENDIX B: EFI ANALYTICAL METHODOLOGY

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This Appendix explains ETAAC's methodology for analyzing and projecting the Electronic Filing Index (EFI).

### PART 1. ESTIMATING THE ELECTRONIC FILING RATE

#### The Electronic Filing Index

ETAAC has identified several different measures used over the years to report and measure the electronic filing rate. To create a consistent measure of this goal, standardize cross-year comparisons, and to facilitate analysis, ETAAC has developed the electronic filing index (Index) for use in its Annual Report to Congress. The Index aggregates and assesses the electronic filing rates of a defined set of major tax returns, and includes a methodology for projecting e-file rates based on "season to date" information about the main driver of electronic filing rates – the individual tax return. The Index computes both a specific electronic filing rate for each specified return family, as well as an overall composite rate that represents the overall electronic filing rate for all major return families in the Index. Importantly, because certain information in IRS Publication 6186 is estimated, ETAAC's Index may shift slightly from year to year as IRS updates its estimates with actual filing season results.

#### Return Families

The Index is computed using IRS Publication 6186's reported information for designated forms in six major return families:

**Individual Income Tax**

Forms 1040, 1040-A, and 1040-EZ

**Partnership**

Forms 1065/1065-B

**Employment Returns**

Forms 940, 940-EZ and 940-PR

Forms 941, 941-PR/SS

**Exempt Organizations**

Form 990

Form 990-EZ

**Corporation Income Tax**

Forms 1120 and 1120-A Total

Form 1120-S

**Fiduciary**

Form 1041

#### Projected Electronic Filing Index

As noted above, the current year filing season data contained in IRS Publication 6186 is estimated. However, based on actual filing season results, we can utilize real-time data. Therefore, ETAAC has modeled a projection methodology to forecast the current year Index based on two components.

First, ETAAC relies on IRS' estimates from IRS Publication 6186 all major return families other than individual returns. Second, ETAAC projects total filing season individual return e-file rates by extrapolating current filing season "year-to-date" information into "full year" estimates based on historical IRS trend data for the May-October period. Part 2 (below) reflects, at least for the past two years, that the e-file rate for individual returns has decreased by about 3% between April and October because a larger percentage of returns filed in the extension period are on paper.

Based on this methodology, ETAAC estimated the individual return e-filing rate will be approximately 80.38% for the entire filing season 2012, which translates into an overall Index for all major return types in filing season 2012 of 69.81%.

## PART 2. PROJECTING THE FULL YEAR ELECTRONIC FILING INDEX FOR INDIVIDUAL RETURNS

ETAAC has a four-step process for projecting the full year electronic filing rate for individual returns.

### Step 1: Estimate the Actual Current “Year-To-Date” E-File Rate

Determine the current “year-to-date” e-file rate for individual returns based on actual return filing information through 4/27/2012.

**Table 11:** Individual Income Tax Returns – Actual Through 4/27/2012

Individual Income Tax Returns	2011 thorough 4/27/12
	Number of Returns
Total	133,460,000
Efile	111,325,000
<b>E-File %</b>	<b>83.41%</b>

Source: <http://www.irs.gov/newsroom/article/0,,id=257083,00.html>

### Step 2: Estimate the Prior Year E-File Rate Degradation

Compare the year-to-date actual e-file rate through approximately 4/27 with the actual e-file rate for the complete tax filing season for both 2010 and 2011. In both instances, the final e-file rate decreased approximately 3% during the extension period between the April and October filing deadlines. (See Table 14) ETAAC will need to monitor the degradation rate as it could change year to year.

**Table 12:** Historical Partial Season vs. Full Season Data

Individual Income Tax Returns	2010			2011			2011 vs. 2010
	4/30/2010	12/31/2010	Change	4/29/2011	12/31/2011	Change	Change
Total Receipts	129,268,000	142,449,000	10.20%	130,692,000	145,320,000	11.19%	100%
E-File Receipts	93,460,000	98,740,000	5.65%	104,936,000	112,203,000	6.93%	128%
E-File Rate	72.30%	69.32%	-2.98%	80.29%	77.21%	-3.08%	-0.10%

Source: <http://www.irs.gov/newsroom/article/0,,id=239250,00.html>: <http://www.irs.gov/newsroom/article/0,,id=257083,00.html>

### Step 3: Project the Full Year E-File Rate for Individual Returns

Subtract the e-file rate degradation from the actual current year-to-date e-file rate. Using a 4/27/2012 cutoff, the projected full year e-file rate for the individual tax return family is 80.38%.

**Table 13:** 2012 Individual Electronic Filing Rate Projection

Individual (Forms 1040, 1040-A, and 1040-EZ)	2012 Through 4/27/2012		
	Current	Projection Rate	2012 Projection
Total Receipts	133,460,000		
E-File Receipts	111,325,000		
E-File Rate	83.41%	-3.03%	80.38%

Source: <http://www.irs.gov/newsroom/article/0,,id=257083,00.html>

#### Step 4: Project the Full Year E-File Volume for Individual Returns

Multiply the projected e-file rate times the IRS' projected 2012 total individual return volume presented in IRS Publication 6186 – that is, 80.38% times 144,565,800 returns. Then, use this projected return volume to calculate the overall Index rate for all major return types.

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**Electronic Tax Administration Advisory Committee  
Annual Report to Congress:  
Innovating To Meet The Challenge**